

# **THE STRUCTURE OF THE SOCIAL AND ETHICS COMMITTEE IN SOUTH AFRICA AND THE PROTECTION OF NON-SHAREHOLDER CONSTITUENCIES**

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### **Abstract**

In South African company law, shareholders remain to be the only stakeholders to hold a privileged position in the governance of companies because they are the exclusive beneficiaries of the director's fiduciary duties. However, the requirement for certain companies to appoint a Social and Ethics Committee in terms of section 72(4) of the Companies Act 71 of 2008 read with Regulation 43 of the Companies Regulations, 2011, arguably disrupts the traditional focus on exclusive shareholder protection by purporting to offer non-shareholder constituencies' legal recognition.

These provisions require certain companies to report on how the operations of a company impact a broad range of non-shareholder constituencies including employees, the environment, consumers, suppliers, and communities. In this regard, the committee presents as an ideal conduit through which it can sensitize the board of directors of companies to issues of national priority in South Africa such as job creation, adequate housing, anti-corruption, climate change, and access to health care.

However, the ability of the committee to deliver on its mandate and to address the concomitant issues of national priority is curtailed by a plethora of shortcomings and ambiguities. The Companies Act and Regulations contain many contradictions as they refer to generic terms of reference regarding the committee's role and they do not provide clarity regarding its powers, functions, objectives, and purpose. Furthermore, there is much uncertainty regarding the committee's appointment by either the board of directors or the shareholders of the company.

This dissertation examines the philosophical foundation of the committee to determine whether it is conducive for protecting non-shareholder constituencies. The main objective of this dissertation is to examine the committee's legal status and structure. This will entail an analysis of its duties, capacities, and incapacities to determine whether section 72(4) of the Companies Act read with Regulation 43 of the Companies Regulations is a viable mechanism that can be enforced to protect non-shareholder constituencies. This analysis is also conducted to identify gaps in the committee's statutory formulation to develop and recommend a tailor-made stakeholder protection model for South Africa.

Furthermore, a comparative overview of stakeholder protection in the United States and the United Kingdom is undertaken to determine how these countries protect non-shareholder constituencies and to establish whether there are lessons to be drawn that may influence corporate law reform in South Africa.

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Date 21 March 2020

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**Dedication**

This dissertation is dedicated to my parents Thomas Nanyemba, Maria Ndafapawa Nanyemba and my sister, Nangula Ndeapo Nanyemba.

## CHAPTER 1: INTRODUCTION

### 1.1 BACKGROUND AND CONTEXTUALIZATION OF THE RESEARCH PROBLEM

Directors<sup>1</sup> are vested with the authority to manage the affairs of a company<sup>2</sup> and they were traditionally expected to do so in a manner that maximised shareholder wealth.<sup>3</sup> Under classical company law shareholders have been the only stakeholders<sup>4</sup> to hold a privileged position in the governance of companies in that they enjoy the exclusive right to enforce the directors' fiduciary duties by instituting derivative action suits.<sup>5</sup> As such, the interests of other stakeholders, namely non-shareholder constituencies, have held very little relevance.<sup>6</sup> Since the 1930s however, there has been a movement towards the recognition and protection of non-shareholder constituencies.<sup>7</sup>

The South African legislature arguably took cognisance of this paradigm shift by enacting section 72(4) of the Companies Act 71 of 2008 (Companies Act)<sup>8</sup> read in conjunction with Regulation 43 of the Companies Regulations, 2011 (Regulations). This provision requires certain companies to appoint a Social and Ethics Committee (SEC) and is considered to be a

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<sup>1</sup> In terms of section 1 of the Companies Act, 'director means a member of the board of a company, as contemplated in section 66, or an alternate director of a company and includes any person occupying the position of a director or alternate director, by whatever name designated'. The phrase "occupying the position of a director" implies that for purposes of the Act, a person who is not formally appointed as a director may be deemed to be a director if he occupies the position of a director. And the phrase "by whatever name designated" implies that certain persons are regarded as directors even though they may be titled by a different name. This means that the *name or description* is not the most relevant basis to determine whether a person is a director – it is the substance of that person's activities that will determine whether the person is a director or not.

<sup>2</sup> Section 66(1) of the Companies Act 71 of 2008.

<sup>3</sup> *Hutton v West Cork Railway Co* (1883) 23 Ch D 654.

<sup>4</sup> Despite the absence of a universally accepted definition of the term stakeholders, the term can be defined as individuals and constituents that can be reasonably expected to be significantly affected by the operations of the company. It has been suggested that corporate constituents who can show cause that they have contributed to the assets of a company via the means of one factor of production or another such as land, labour, capital or rent should be able to benefit from the protection which corporate law has to offer. See Jean Jacques du Plessis, McConville & M Bagaric *Principles of Contemporary Corporate Governance* (2005) at 24. Also see Lee Roach 'The paradox of the traditional justifications for exclusive shareholder governance protection: expanding the pluralist approach' (2001) 22 *The Company Lawyer* 9 at 18.

<sup>5</sup> David Million 'Radical Shareholder Primacy' (2014) 10 *University of Thomas Law Journal* 4 at 1020.

<sup>6</sup> Irene-Marie Esser and Jean Du Plessis 'The Stakeholder Debate and Director's Fiduciary duties' (2007) 19 *SA Merc LJ* at 347-350.

<sup>7</sup> *Ibid.*

<sup>8</sup> My emphasis.

remarkable stride towards the recognition and protection of non-shareholder constituencies.<sup>9</sup>

The role of the SEC within a company can be described as the company's 'watchdog' insofar as the company's social and ethical footprint is concerned.<sup>10</sup> The SEC can help to ensure that a company's Corporate Social Responsibilities (CSR)<sup>11</sup> are embedded in the core of the company's activities and strategies to add value beyond making profits.<sup>12</sup> The presence of a structured committee such as the SEC in a company not only serves as a critical co-ordination function but it can also help to ensure that the company is steered with an integrated perspective on business development.<sup>13</sup> Further to that, the SEC serves as a means through which a company can efficiently and effectively manage risks deriving from economic, environmental and social settings that may have an impact on the operations of a company.<sup>14</sup>

However, the contribution made by the legislature in the Companies Act and Regulations as an effort to recognise and protect the interests of non-shareholder constituencies is counterintuitive.<sup>15</sup> First, there is no express reference to the effect that the mandate of the committee is to monitor the company's non-financial performance of the company.<sup>16</sup> And secondly, the term 'ethics' is not mentioned in the Act nor the Regulations besides in the name of the committee.<sup>17</sup>

These two shortcomings represent many of the other ambiguities that render the current formulation of the SEC inadequate to protect non-shareholder constituencies. The next section of this dissertation examines some of the said shortcomings of the committee.

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<sup>9</sup> Helena Stoop 'Towards Greener Companies-Sustainability and the Social and Ethics Committee' (2013) 24 *STELL LR* 3 at 574.

<sup>10</sup> *Ibid.*

<sup>11</sup> The term Corporate Social Responsibility is underscored by the notion that directors are required to provide an account for the non-financial performance of the company. Despite the absence of a universally accepted definition of what is generally described as corporate conscience or responsible corporate citizenship; the term denotes the management of corporate affairs by achieving a balance of economic and social imperatives. See Dartey-Baah Kwasi and Amponsah-Tawiah Kwes 'Exploring the limits of Western Corporate Social Responsibility Theories in Africa' (2011) 2 *International Journal of Business and Social Science* 18 at 126-127.

<sup>12</sup> My emphasis.

<sup>13</sup> My emphasis.

<sup>14</sup> *Op cite* note 8 at 564.

<sup>15</sup> Henk Kloppers 'Driving Corporate Social Responsibility through the Companies Act: An overview of the role of the Social and Ethics Committee' (2013) 16 *PELJ* 1 at 167.

<sup>16</sup> *Ibid.*

<sup>17</sup> *Op cite* note 9 at 578.

## *1.2 The Shortcomings, Uncertainties, and Ambiguities of the Social and Ethics Committee*

The inefficacy of the SEC stems from a plethora of ambiguities and uncertainties that emanate from the legislature's poor formulation of section 72(4) of the Companies Act read with Regulation 43. There are virtually no mechanisms provided by the Companies Act and Regulations to ensure that the committee is anything more than window dressing for companies that may be masked as a marketing tool.<sup>18</sup> In this regard, the failure to address the shortcomings and uncertainties regarding the SEC gravely undermines its efficacy and ability to steer the company's CSR strategy.<sup>19</sup>

### *1.2.1 The Requirement to Appoint a Social and Ethics Committee*

In terms of section 72(4)(a) of the Companies Act, the Minister of Trade and Industry may (by way of Regulations) prescribe the establishment of an SEC for certain categories of companies. The requirement for companies to establish an SEC will be determined by the Minister in terms of their annual turnover, the size of the workforce and the nature and extent of their activities. In terms of the Regulations, all state-owned companies, listed public companies and companies that have a public interest score above 500 points in the previous five years must have SEC<sup>20</sup>

It is not clear why the consideration of social and ethical issues is only limited to certain categories of companies bearing in mind that it would be prudent for all companies, regardless of size, to be concerned with social and ethical issues.<sup>21</sup> However, one must also bear in mind that the Companies Act also prescribes for the establishment of other committees such as the Audit Committee and thus, it would be impracticable and expensive for smaller companies to appoint all prescribed and/or recommended committees.<sup>22</sup>

The Companies Tribunal (Tribunal) may exempt a company from the requirement to establish an SEC.<sup>23</sup> Such exemption may be granted if the Tribunal is satisfied that the company has a pre-existing formal mechanism that already performs the substantial functions of the SEC or if such a company is required to have such a committee in terms of other legislation.<sup>24</sup> This exemption may also be granted if the Tribunal believes that having regard to the nature and extent of the company's activities, it is not reasonably necessary in the public interest for the

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<sup>18</sup> My emphasis.

<sup>19</sup> My emphasis.

<sup>20</sup> Regulation 43(1) of the Companies Regulations, 2011.

<sup>21</sup> My emphasis.

<sup>22</sup> Natasha Bouwman 'Board Committees' (2010) 10 *Without prejudice* 2 (2010) at 11.

<sup>23</sup> Section 72(5).

<sup>24</sup> Section 72(5)(a).

company to appoint a SEC.<sup>25</sup>

The exemption to appoint a SEC is perhaps aimed at reducing the administrative costs of maintaining such a committee and to avoid duplicating tasks within the company.<sup>26</sup> However as mentioned before, given the impact which the operations of any company can have on the economy, it is questionable whether it is ever in the public interest for a company not to be concerned with its social and ethical footprint, regardless of the nature of its operations.<sup>27</sup>

### *1.2.2 The Mandate and Functions of the Social and Ethics Committee*

The SEC has the potential to enhance the governance of the social and ethical performance of companies. However, there are various deficiencies and ambiguities regarding the mandate, role, and functions of this committee.

The mandate of the SEC includes monitoring and reporting functions. In this regard, the SEC is required to monitor the company's activities concerning social and economic development; good corporate citizenship, the environment, health and public safety, consumer relationships and finally, labour and employment.<sup>28</sup> The SEC is also required to monitor the company's compliance with the 10 principles of the United Nations Global Compact principles; the Organisation for Economic Co-operation and Development recommendations regarding corruption, the Employment Equity Act and the Broad-Based Black Economic Empowerment Act.<sup>29</sup>

The mandate of the SEC encapsulates a core component of good corporate governance<sup>30</sup> because it plays an instrumental role in ensuring the protection of non-shareholder constituency interests within the company. As such, the role of the SEC is to ensure that the company integrates both business and sustainability priorities in its practices so that it can thrive in an economy that strives to align companies with the principles of fairness and equality espoused in the South African Constitution.<sup>31</sup>

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<sup>25</sup> Section 72(5)(b).

<sup>26</sup> My emphasis.

<sup>27</sup> Ibid.

<sup>28</sup> Reg 43(5)(a).

<sup>29</sup> Ibid.

<sup>30</sup> Notwithstanding the absence of a universally accepted definition of the term 'corporate governance', the concept generally refers to the set of legal, cultural and institutional arrangements that determine how a corporation is administered, controlled and directed. Central to the concept of corporate governance is how the board of directors conducts itself and how it governs the company. Corporate governance is concerned with the relationship between the board of directors and other participants such as shareholders, employees, creditors and the community at large. See Op cite note 4 at 3-5.

<sup>31</sup> Act 108 of 1996.

Furthermore, the mandate placed on companies to monitor the activities mentioned in Regulation 43(5)(a) arguably refers to the legal recognition and protection of non-shareholder constituencies such as employees, customers, environment and communities.

However, the legislature's use of the word "monitor" implies that the SEC is merely required to keep a record of how the company's activities impact non-shareholder constituencies and to observe whether the company's CSR activities are carried out correctly.<sup>32</sup> As such, based on the wording used in the Companies Act and Regulations, it is not clear whether monitoring non-shareholder constituency interests is the same as legally recognising or protecting their interests.<sup>33</sup>

In addition to the SEC's functions and mandate outlined above, the committee is also required to occasionally draw the attention of the board of directors on these matters as its members may deem necessary<sup>34</sup>. Furthermore, one of committee's members is required to report to the shareholders at the annual general meeting regarding matters that fall within its mandate.<sup>35</sup>

### *1.2.3 The Rights of the Social and Ethics Committee*

Pursuant to section 72(8)(b) of the Companies Act, the SEC has the right to request from the any employee of the company any information or explanation necessary for the performance of the committee's functions. In addition to this, the SEC also has the right to be heard at a general shareholder's meeting in terms of section 72(8)(e) regarding any part of the meeting that concerns the committee's functions.

The right extended to employees in terms of section 72(8)(b) can be interpreted to mean that they are the only non-shareholder constituencies who may make contributions to the CSR strategy of the company. This places the employees in a position to make suggestions regarding how the company can protect their interests and the interests of other non-shareholder constituencies. However, this right is limited because it is not coupled with the decision-making powers to effect or to enforce the said contributions.

And pursuant to section 72(8)(e), neither do the members of the SEC have the right to enforce the decisions made by the committee as they simply make recommendations which are presented at Annual General Meeting. In this regard, the board of directors simply acquaints

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<sup>32</sup> My emphasis.

<sup>33</sup> My emphasis.

<sup>34</sup> Reg 43(5)(b)

<sup>35</sup> Reg 43(5)(c).

itself with the SEC's report without necessarily making any useful implementation strategies.

#### 1.2.4 Terms of Reference

The Companies Act and Regulations refer to generic terms of reference regarding the role and responsibilities of the SEC.<sup>36</sup> The powers, functions, objectives, and purpose of the SEC are not made clear.<sup>37</sup>

First, in monitoring labour and employment issues<sup>38</sup> as an effort to recognise and protect the interests of employees as stakeholders, the Regulations refer to non-existent legal instruments. According to Rossouw, the Department of Trade and Industry confirmed that the *Organization Protocol on Decent Work and Working Conditions* does not exist.<sup>39</sup> It is, however, possible that it was perhaps the legislature's intention to refer to a document titled *Decent Work Country Profile: South Africa (ILO 2012)*<sup>40</sup> or perhaps the *International Labour Organisation Decent Work Agenda*.

The documents mentioned above are published by the International Labour Organisation (ILO) to guide companies and other organisations on issues relating to job creation, rights at work, decent work and working conditions.<sup>41</sup> The legislature's failure to refer to the two documents mentioned above instead of the non-existent *Organization Protocol on Decent Work and Working Conditions* negates the protection of employees. Thus, the members of the SEC will have to make a value judgement in selecting the various laws, codes, and conventions that may be relevant for purposes of ensuring the protection of employees as stakeholders within the company.

Secondly, in terms of regulation 43(5)(a)(i), the SEC is to be guided by the United Nations Global Compact Principles and the OECD Recommendations regarding Corruption in fulfilling its monitoring role. This prescription is rather peculiar especially when one considers that the Regulations refer to these internationally recognised corporate governance instruments

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<sup>36</sup> Op cite note 9 at 577.

<sup>37</sup> Irene-Marie Esser and Piet Delpont 'The Protection of Stakeholders: The South African Social and Ethics Committee and the United Kingdom's Enlightened Shareholder value approach: Part 2' (2017) 50 *De Jure* 1 at 229.

<sup>38</sup> Reg 43(5)(v).

<sup>39</sup> Dean Rossouw *The Social and Ethics Committee Handbook* 2 ed (2018) at 24.

<sup>40</sup> Ibid.

<sup>41</sup> International Labour Organisation 'Decent Work Country Profile –South Africa (Pre-publication draft) available at [https://www.ilo.org/integration/resources/pubs/WCMS\\_232765/lang--en/index.htm](https://www.ilo.org/integration/resources/pubs/WCMS_232765/lang--en/index.htm) accessed on 25 June 2019.

instead of national instruments.<sup>42</sup> Kloppers correctly submits that the reference to international instruments instead of the local instruments such as the *King Reports on Corporate governance in South Africa* or the *Guidance on Social Responsibility* is a grave oversight on the legislature's part.<sup>43</sup> Reference to these local codes would have incorporated these instruments into our legal jurisprudence as soft law.<sup>44</sup>

#### *1.2.5 The Composition of the Social and Ethics Committee*

According to the Regulations, the SEC must comprise no less than three directors or prescribed officers and one of whom must be a non-executive director.<sup>45</sup>

The requirement to have only one non-executive director on the SEC stands in stark contrast with the best practice recommendations of the King IV Report.<sup>46</sup> The King IV Report recommends a higher standard for the SEC and suggests that the committee should be comprised of a majority of non-executive directors.<sup>47</sup>

The membership of the SEC should be determined very carefully to ensure that the committee is comprised of members with adequate knowledge on issues that concern the protection of non-shareholder constituencies and to ensure that the duties of its members are discharged without unfettered discretion.<sup>48</sup>

The presence of persons on the SEC with CSR expertise or at a minimum experience with CSR will provide the company with an opportunity to balance stakeholder expectations in their decision making.<sup>49</sup> Members of the SEC who lack knowledge in CSR will not be able to guide the board and mitigate the company's exposure to social and ethical risks.<sup>50</sup>

The primary motivation for having non-executive directors on the SEC is arguably for them to provide an objective judgement in the strategic management of the company in matters which pertain to the protection of non-shareholder constituency interests.<sup>51</sup> This is because non-executive directors are expected to discharge their duties in a detached manner and to provide independent oversight over executive directors.<sup>52</sup>

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<sup>42</sup> Op cite note 15 at 173.

<sup>43</sup> Ibid.

<sup>44</sup> Ibid.

<sup>45</sup> Regulation 43(4) of the Companies Regulations.

<sup>46</sup> Op cite note 9 at 575.

<sup>47</sup> King IV Report on Corporate Governance at 29-30.

<sup>48</sup> My emphasis.

<sup>49</sup> Ibid.

<sup>50</sup> Ibid.

<sup>51</sup> Ibid.

<sup>52</sup> *Howard v Herrigel* 1991 2 ALL SA 113 (A).



Having SEC members who are independent, not only in appearance but also in judgement is essential for purposes of fostering enhanced accountability for poor corporate performance.<sup>53</sup> As such, the membership of the SEC should be determined very carefully to ensure that the committee is comprised of members with adequate knowledge on CSR issues and to ensure that the duties of the SEC are discharged without unfettered discretion.<sup>54</sup>

### *1.2.6 A Comparison of the Social and Ethics Committee with the Audit Committee*

The Companies Act gives the board of directors the authority to appoint several committees<sup>55</sup> but the Audit Committee and the SEC are the only two committees prescribed by the Act. Although the Act gives these two committees statutory recognition, a comparison between them brings to light certain inconsistencies in the Act.<sup>56</sup>

First, the functions of the Audit Committee are regulated by the Act itself and not the Regulations as is the case with the SEC. The intention of the legislature in this regard and whether there are any legal implications for regulating the mandate of the SEC via the Regulations as opposed to the Companies Act is not clear.

Secondly, the Act and Regulations do not mention anything about the skillset of the members who serve on the SEC. This position is strange considering that the skillset of the members of the Audit Committee is prescribed by the Minister of Trade and Industry in Regulation 42 of the Companies Regulations.

Finally, Section 94(2) of the Companies Act, makes it clear that members of the Audit Committee are to be appointed by the shareholders and not by the directors. However, pursuant to Regulation 43 of the Regulations, it is not clear whether the SEC is to be appointed by the shareholders or the board of directors.

### *1.3 Problem Statement*

The overall success of the SEC is contingent upon four attributes that may be assessed to evaluate the performance of the SEC's members in their role of protecting the interests of non-shareholder constituencies. These attributes are composition, characteristics, structure, and process.<sup>57</sup>

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<sup>53</sup> My emphasis.

<sup>54</sup> My emphasis.

<sup>55</sup> Section 72(1).

<sup>56</sup> My emphasis.

<sup>57</sup> Shaker Zahra and John Pearce 'Boards of Directors and Corporate Financial Performance: A Review and Integrative Model' (1989) 15 *Journal of Management* 2 at 292.

Composition refers to the size of the SEC and the mix of executive and non-executive directors who sit on the SEC.<sup>58</sup> Characteristics refer to the ability of the committee to discharge its duties with unfettered discretion and the relative qualifications and experience possessed by each of its member.<sup>59</sup> Process refers to the style in which the SEC executes decisions.<sup>60</sup> And finally, structure refers to the division of power in a company, the efficiency of the operations the SEC and, the legal status of the SEC which includes an analysis of its duties, capacities, and incapacities.

### *1.3.1 The Appointment of the Social and Ethics Committee and the Implications on its Legal Status*

As mentioned previously, the position regarding the appointment of the SEC in the Regulations is ambiguous. The uncertainty regarding its appointment arguably has a bearing on the committee's legal status and the standard of conduct and liability attributable to its members.<sup>61</sup> As such the legal status of the SEC is the most prominent of all its uncertainties and shortcomings. Accordingly, the legal status of the SEC has been the subject of much debate.

Esser correctly submits that there appears to be a lack of consensus in the literature available regarding the appointment of the SEC.<sup>62</sup> Various commentators have different classifications regarding whether the SEC is appointed by either the board of directors and is thus a board committee or whether it is appointed by the shareholders and is accordingly a separate organ of the company.<sup>63</sup>

Regrettably, the Companies Act and Regulations do not state with certainty whether the committee is to be appointed by the board of directors or the shareholders. What is more is that between the Companies Act and Regulations, neither provide adequate mechanisms to ensure that once the SEC is appointed it does its job. In addition to this, 'the most onerous sanction for not appointing an SEC is an intervention by the Companies Tribunal'.<sup>64</sup>

Furthermore, Cassim correctly points out that there is no enforcement mechanism provided in the Act nor Regulations which can be enforced by the non-shareholder

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<sup>58</sup> Ibid.

<sup>59</sup> Ibid.

<sup>60</sup> Ibid.

<sup>61</sup> Op cite note 37 at 224.

<sup>62</sup> Ibid at 223.

<sup>63</sup> Ibid at 223-224.

<sup>64</sup> Op cite note 9 at 576.

constituencies that the committee seeks to protect.<sup>65</sup> This means that there are no legal consequences for the SEC for failing to ensure that the protection of non-shareholder constituencies is embedded into the company's strategy and objectives.

The absence of an enforcement mechanism stems from a failure to formally recognise non-shareholder constituencies as corporate constituents with enforceable rights against the company. As a consequence, the current formulation of the SEC as prescribed by the Companies Act and Regulations merely asks of its members to monitor the interests of non-shareholder constituencies, it does not ensure or guarantee the protection of their interests.

#### *1.4 Objectives, Rationale and Scope of the Dissertation*

This dissertation examines the structure of the SEC to demonstrate how its legal status negates its efficacy to protect non-shareholder constituencies. The structure of the SEC will be analysed because the efficiency of the SEC and the ability of its members to protect non-shareholder constituencies will depend upon the enforceability of the rights which section 72(4) purports to afford non-shareholder constituencies.

Accordingly, this dissertation will investigate whether section 72(4) of the Companies Act read with Regulation 43 of the Companies Regulations is a legally viable provision that can be enforced to protect the interests of non-shareholder constituencies.

It is prudent to highlight that a critical analysis that would address all the shortcomings and uncertainties surrounding the SEC is beyond the scope of this dissertation. As such, the focus of this dissertation will be based specifically on the legal status and structure of the SEC. This dissertation will not analyse the composition, characteristics, and process of the SEC.

For purposes of this dissertation, the term non-shareholder constituencies, except where mentioned specifically, refers to stakeholders other than shareholders. Although shareholders form part of the broader concept of stakeholders, shareholders will be dealt with separately from all other corporate constituents that are also stakeholders.

Furthermore, this dissertation will not focus on a specific constituent of stakeholders. The focus will be on the contrast in the protection offered to the shareholders versus the collective group of non-shareholder constituencies.

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<sup>65</sup> Farouk Cassim, Maleka Cassim and Rehanna Cassim et al *Contemporary Company Law* 2 Ed (2012) at 523.

### 1.5 Research Question

Can section 72(4) of the Companies Act read in conjunction with Regulation 43 of the Companies Regulations, 2011 be enforced as a legally viable mechanism to protect the interests of non-shareholder constituencies?

### 1.6 The Significance of the Research Problem

The advent of South Africa's democratic dispensation was a critical driver for corporate social and ethical responsibility.<sup>66</sup> The dawn of the new political dispensation in 1994 brought about a paradigm shift that affects the social dimension of the corporate law discipline in the country.<sup>67</sup>

In addition to this, South Africa's re-entrance into the world economy following the atrocities committed by the Apartheid government underscored the need to reform the country's corporate law regime.<sup>68</sup> This transformation was a necessary effort to advance a sustainable economy that would meet the needs of its people considering that the poor governance of companies can serve as a systemic risk on the economy and the country as a whole.<sup>69</sup>

The Constitution, and specifically the Bill of Rights, seeks to ensure the common welfare of all South Africans.<sup>70</sup> The Bill of rights contains a wealth of provisions that relate to workplace rights,<sup>71</sup> socioeconomic rights<sup>72</sup> and it also guarantees the protection of the environment.<sup>73</sup> The protection of these rights is considered to be an issue of national priority<sup>74</sup>

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<sup>66</sup> David Bilchitz 'Corporate Law and the Constitution: Towards Binding Human Rights Responsibilities for Corporations' 25 *SALJ* 1 at 772.

<sup>67</sup> Michelle Havenga 'Regulating Director's Duties and South African Company Law Reform' (2005) 26 *Obiter* 3 at 612.

<sup>68</sup> *Ibid.*

<sup>69</sup> My emphasis.

<sup>70</sup> Chapter 2, sections 7-39 of The Constitution.

<sup>71</sup> Section 23 of the Constitution.

<sup>72</sup> Section 27 of the Constitution.

<sup>73</sup> Section 24 of the Constitution.

<sup>74</sup> In 2019 at the State of the Nation Address, President Cyril Ramaphosa highlighted seven key areas that the South African government would focus on. The seven key areas of focus are: economic transformation and job creation, education, skills and health, consolidating the social wage through reliable and quality basic services, spatial integration, human settlements and local government, social cohesion and safe communities, a capable, ethical and developmental state and the promotion of a better Africa and the world. These key areas are commonly referred to as issues of national priority. See generally, South African Government 'President Cyril Ramaphosa: State of the Nation Address 2019' available at <https://www.gov.za/speeches/2SONA2019>, accessed on 7 February 2020.

in as much as they are also matters which fall within the SEC's ambit of responsibilities.<sup>75</sup>

One of the main objects of the Companies Act is to promote and give effect to the Bill of Rights as entrenched in the Constitution. Section 5 read in conjunction with section 7(d) of the Companies Act encourages high standards of corporate governance, the responsible management of companies and reaffirm the concept of the company as means of achieving economic and social benefits.

As such, the introduction of a SEC as encapsulated in section 72(4) of the Companies Act reflects the position espoused in section 5 read with section 7 and arguably gives credence to the proposition that the protection of employees, the community, the environment and the concomitant issues of national priority may be taken into consideration by directors in the discharge of their duties.<sup>76</sup>

The protection of workplace, socioeconomic and environmental rights afforded by the Constitution presents binding obligations for companies based on the horizontal applicability of the Constitution.<sup>77</sup> The Constitution not only applies vertically between the state and individuals it also applies horizontally between individuals themselves, which includes juristic persons such as companies.<sup>78</sup> As such, companies can play a significant role in addressing issues of national priority such as the long term provision of health and educational services and the overall alleviation of poverty.<sup>79</sup>

The horizontal application of the Constitution thus presents a paradigm shift in the manner in which companies conduct their activities.<sup>80</sup> In this regard, the SEC presents as an ideal conduit through which it can sensitize the board of directors to issues of national priority and the concomitant protection of non-shareholder constituency interests to ensure that the company does not fall foul of the provisions of the Bill of Rights prescribed by section 7 read with section 5 of the Companies Act.<sup>81</sup>

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<sup>75</sup> My emphasis.

<sup>76</sup> My emphasis.

<sup>77</sup> Op cite note 66 at 774.

<sup>78</sup> Ibid.

<sup>79</sup> Hendrick Botha 'Corporate Governance, Leadership and Ethics: Interrelated trio' (2009) 25 *Management Today* 2 at 55.

<sup>80</sup> Op cite note 66 at 756.

<sup>81</sup> My emphasis.

### *1.7 Research Methodology and Structure*

The research for this dissertation is analytical and literature based. The dissertation will analyse both primary and secondary sources of law. The central focus of this dissertation will be on the SEC pursuant to section 72(4) of the Companies Act read in conjunction with Regulation 43 of the Companies Regulations.

Chapter one of this dissertation introduces the context within which the SEC operates. This chapter also establishes the background of the research problem and the significance thereof.

Chapter two establishes the philosophical underpinning of the dissertation. This chapter encompasses a literature review of the shareholder value theory versus the stakeholder theory. A review of the two schools of thought mentioned above is necessary for purposes of analysing and determining the approach undertaken by the Companies Act to protect the interests of non-shareholder constituencies.

Chapter three examines the legal status and structure of the SEC. This chapter will serve as the crux of the dissertation as it will encompass the response to the research question, that is, whether section 72(2)(4) read with Regulation 43 is a viable mechanism that can be enforced to protect non-shareholder constituencies.

Chapter four contains a comparative analysis that investigates the various legal instruments used in the United Kingdom and the United States of America to protect non-shareholder constituencies.

Chapter five will contain the conclusion, recommendations to the South African legislature and areas for future research.

## CHAPTER 2: THE THEORETICAL FOUNDATION OF THE SOCIAL AND ETHICS COMMITTEE

### 2.1 INTRODUCTION

The philosophical foundation of a country's corporate law regime determines the overriding objective of companies operating in that particular jurisdiction and to whose benefit the company is administered, controlled and directed.<sup>82</sup> Accordingly, the philosophical foundation also establishes the scheme of responsibilities to stakeholders that can be enforced.

In this regard, there are two general theories.<sup>83</sup> The first is the shareholder primacy theory and the second is the stakeholder theory.<sup>84</sup> It is important to highlight that the theories regarding the corporate objective represent a complex area of the law as there are many nuances and variations.<sup>85</sup> Variations of the theories include, *inter alia*, the enlightened shareholder value theory, communitarian theory, and the pluralist theory.<sup>86</sup> The variations of the theories are not sacrosanct but the shareholder primacy and stakeholder theory merely represent both ends of the spectrum.<sup>87</sup>

As demonstrated in Chapter 1, the overriding mandate of the SEC is to ensure that the company monitors how the operations of the company impact non-shareholder constituencies.<sup>88</sup> This mandate arguably only offers non-shareholder constituencies' limited legal recognition because of the absence of an enforcement mechanism that would have offered legal standing and protection.

This chapter analyses how the philosophical foundation of the SEC negates the presence of an enforcement mechanism. This chapter reviews the contrast in the protection offered to stakeholders by the shareholder primacy theory versus the stakeholder theory. The objective of this chapter is to provide critical analysis of the approach adopted in South African company law to demonstrate why and how the philosophical foundation of the SEC negates the protection of non-shareholder constituencies.

An analysis of all variants of the theories mentioned above is beyond the scope of this

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<sup>82</sup> Andrew Keay 'Stakeholder Theory in Corporate Law: Has it Got What It Takes' (2010) 9 *Richmond Journal of Global Law and Business* 3 at 249.

<sup>83</sup> Op cite note 65 at 518.

<sup>84</sup> Ibid.

<sup>85</sup> Op cite note 6 at 355.

<sup>86</sup> Ibid.

<sup>87</sup> Ibid.

<sup>88</sup> See Chapter 1 at 5.

dissertation. As such, the analysis will be limited to the shareholder primacy theory versus the stakeholder theory and the enlightened shareholder value theory.

## 2.2 The Shareholder Primacy Theory

The modern form of a corporate entity entails that ownership and control are vested in two distinct bodies, namely shareholders who “own”<sup>89</sup> the company and directors who manage the affairs of the company.<sup>90</sup> As an effect of the divorce between ownership and control in a company, shareholders expect the directors to maximise their wealth by managing the affairs of the company in good faith and to act in the ‘best interests of the company’.<sup>91</sup>

Accordingly, the quintessence of the shareholder primacy theory holds that directors are to give primacy to the interests of shareholders.<sup>92</sup> Thus, the shareholder primacy theory is founded on the notions of private ownership by the shareholders of the company’s assets and shareholder wealth maximization to enhance economic efficiency.<sup>93</sup>

The ownership argument can be traced back to several cases which equated the interests of the company to be synonymous with the interests of the shareholders. In *Greenhalgh v Arderne Cinemas Ltd*<sup>94</sup> the court declared that the company as a whole is essentially an entity that consists of all the shareholders. In *Parke v Daily News Ltd*<sup>95</sup> the court equated the benefit of the company with the benefit of the shareholders. And in *Gaiman v National Association for Mental Health*<sup>96</sup> it was noted that an attempt to determine what the best interests of the company are, due regard must be given to the interests of the shareholders.

The phrase ‘best interests of the company’ has been interpreted to mean the collective interests of past, present and future shareholders. This narrow approach to conducting the affairs of the company was based on 18<sup>th</sup> and 19<sup>th</sup>-century judicial interpretations.

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<sup>89</sup> It is crucial to highlight that it is incorrect to refer to shareholders as the owners of the company. Shareholders own shares in a company which entitles them to several legal rights, shareholders do not own the company itself as an entity. See Rehana Cassim ‘The Power to Remove Company Directors from Office: Historical and Philosophical Roots’ (2019) 25 *Fundamina* 1 at 51.

<sup>90</sup> Ibid at 51.

<sup>91</sup> *Re Smith and Fawcett Ltd* [1942] Ch 304 at 306. Also see section 76(3)(b) of the Companies Act.

<sup>92</sup> Jingchen Zhao ‘The Curious Case of Shareholder Primacy Norm: Calling for a More Realistic Theory’ (2012) *International Trade and Business Law Review* 15 at 1-2.

<sup>93</sup> Ibid at 8.

<sup>94</sup> [1951] Ch. 286.

<sup>95</sup> [1962] Ch. 963.

<sup>96</sup> [1971] Ch 317 at 330.



The English case of *Hutton v West Cork Railway Co*<sup>97</sup> and the American ruling in *Dodge v Ford Motor Co*<sup>98</sup> both advanced the shareholder wealth maximization norm. The rulings of these two cases provide authority for the strict utilization of the company's resources to maximise shareholder wealth to the exclusion of other stakeholders. Therefore, in terms of the shareholder primacy theory, the shareholders are the sole beneficiaries of the director's fiduciary duties.<sup>99</sup> As such, the success of the company and the maximisation of shareholder wealth is the overriding objective for directors when managing the affairs of the company.<sup>100</sup>

### 2.2.1 The Justifications for the Shareholder Primacy Theory

The most common justification for the shareholder primacy theory is based on the archaic and incorrect assumption that the shareholders are the owners of the company.<sup>101</sup>

Another justification for shareholder primacy is based on the residual risk argument.<sup>102</sup> In terms of this argument, shareholders have a legitimate, direct and sole interest in the company's financial wellbeing and executive interests, including the fiduciary duties of directors.<sup>103</sup> As such, the shareholders are deemed to be the residual claimants of the company's assets because they only receive whatever surplus remains when a company is wound up.<sup>104</sup>

Arguing against the stakeholder theory, Friedman contends that the consideration and protection of non-shareholder constituencies demands of directors to act as civil servants.<sup>105</sup> According to the scholar, the theory permits directors to make use of the shareholder's investment in a company to promote and advance social welfare.<sup>106</sup>

It is submitted that the protection and/or recognition of the interests of non-shareholder constituencies does not substitute the role of directors for that of civil servants. The stakeholder theory merely encourages directors, in advancing the interests of the company, to ensure the sustainable development of the company.

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<sup>97</sup> *Hutton v West Cork Railway Co* (1883) 23 Ch D 654

<sup>98</sup> *Dodge v Ford Motor Co* (1919) 170 NW 668.

<sup>99</sup> *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch. 286 at 291.

<sup>100</sup> *Cohen v Segal* 1970 (3) SA 702 (W) 706.

<sup>101</sup> Op cite note 89 at 51.

<sup>102</sup> Lee Roach 'The Paradox of the Traditional Justifications for Exclusive Shareholder Governance Protection: Expanding the Pluralist Approach' (2001) 22 *The Company Lawyer* 9 at 11-13.

<sup>103</sup> Ibid.

<sup>104</sup> Ibid.

<sup>105</sup> Milton Friedman 'The Social Responsibility of Business is to Increase its Profits' 1970 *The New Times Magazine* at 3.

<sup>106</sup> Ibid.

### 2.2.2 *The Shortcomings of the Shareholder Primacy Theory*

The assertion that shareholders are the owners of the company is incorrect for two reasons. First, the shareholders have no vested interest in the property of a company; shareholders only have a right to claim a dividend because their investment in a company does not entitle them to claim part-ownership in the property of the company.<sup>107</sup>

Secondly, the premise of the shareholder primacy theory misplaces shareholder wealth maximization at the epicentre of directorial common law fiduciary duties.<sup>108</sup> This position inadvertently disregards the true purpose of fiduciary duties which is to prevent directorial self-serving misconduct and to protect the company from the abuse of its separate legal personality.<sup>109</sup> As such, the shareholder primacy theory contradicts the fundamental principle of company law that a company is a separate legal entity.

From the moment of incorporation, the company assumes a separate legal personality which is akin to that of a natural person and is thus incapable of being owned.<sup>110</sup> In terms of *Salomon v A Salomon*<sup>111</sup>, the court opined that directors generally owe fiduciary duties to the company as a separate legal person distinct from the shareholders of the company. Directors are thus engaged primarily to be stewards of the affairs of the company and not to act as agents on behalf of the shareholders.<sup>112</sup> As a consequence, it is only the company (and the company alone) that can enforce fiduciary duties against directors who fail to fulfil their fiduciary duties

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<sup>107</sup> *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530 at 550-551.

<sup>108</sup> Tshepo Mongalo *Corporate Actions and the empowerment of non-shareholder constituencies* LLD thesis (2015) University of Cape Town at 1.

<sup>109</sup> *Ibid.*

<sup>110</sup> *Salomon v A Salomon & Co Ltd* 1897 AC 22; 1895-99 All ER Rep 33 (HL): (“the company is at law a different person altogether from the subscribers”, per Lord Macnaghten 51; 48; “once a company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself”, per Lord Halsbury LC 30; 35); *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530 550: (“a registered company is a legal *persona* distinct from the members who compose it”, per Innes CJ); *JH Rayner (Mincing Lane) Ltd v Department of Trade and Industry* 1990 2 AC 418 482 515; *sub nom MacLaine Watson & Co Ltd v Department of Trade and Industry* 1989 3 All ER 523 (HL) 531 549; *Adams v Cape Industries plc* 1990 Ch 433; 1991 1 All ER 939 (CA); *The Shipping Corporation of India Ltd v Evdomon Corporation & The President of India* 1994 2 All SA 11 (A); 1994 1 SA 550 (A) 565-566. See also eg *Francis George Hill Family Trust v SA Reserve Bank* 1992 2 All SA 137 (A); 1992 3 SA 91 (A) 97 per Hoexter JA: It is trite that a company with limited liability is an independent legal person and separate from its shareholders or directors.”

<sup>111</sup> *Salomon v A Salomon & Co Ltd* [1897] AC 22).

<sup>112</sup> *Sharp and Others v Blank and Others* [2015] EWHC 3220 (Ch) at para 40.9.

as set out in the Companies.<sup>113</sup>

However, since a company is an artificial legal person and thus cannot act on its own, the shareholders may under certain circumstances institute derivative actions on behalf of the company when the directors are unable or unwilling to do so.<sup>114</sup>

The reformed derivative action is embodied in section 165 of the Companies Act and thus serves as an exception to the rule that the company is the ‘proper plaintiff’ to remedy any wrongs done to it.<sup>115</sup>

In terms of section 165(2), a person (with legal standing and leave from the court) such as a shareholder, a director, a prescribed officer, a trade union or another employee representative can institute derivative action proceedings. Thus, it follows that shareholders (and a trade union or another employee representative) can rely on section 165(2) to enforce fiduciary duties against errant directors.

However, to this day there has only been one company that successfully litigated against its directors for negligence. That was the case of *Niagara Ltd v Langerman*.<sup>116</sup> As such, given the paucity of successful cases in this regard, the shareholders’ (and employee’s representatives’) chances of successfully protecting the interests of non-shareholder constituencies will remain to be seen.

### 2.3 The Stakeholder Theory

In terms of the stakeholder theory, the corporate objective is to ensure that directors manage the affairs of the company for the benefit of all stakeholders and not only the shareholders.<sup>117</sup> As such, all stakeholders are deemed to be beneficiaries of fiduciary duties.<sup>118</sup>

The stakeholder theory is premised on the act of weighing, assessing and balancing the interests of legitimate and identifiable stakeholders.<sup>119</sup> The protection of non-shareholder constituencies is largely based on the argument which contends that the resources of a company should be utilized in a manner that benefits those who contribute to the capital of the company.<sup>120</sup> Given the effect which the operations of a company can have on society and the

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<sup>113</sup> This is an established practice in company law that is commonly expressed as the proper plaintiff rule. See *Foss v Harbottle* (1843) 2 Hare 461 which is the leading case in this regard.

<sup>114</sup> *Alexander Ward & Co Ltd v Samyang Navigation Co Ltd* [1975] 2 All ER 424 (HR).

<sup>115</sup> Section 165(1) of the Companies Act.

<sup>116</sup> 1913 WLD 188.

<sup>117</sup> Op cite note 82 at 256.

<sup>118</sup> Ibid.

<sup>119</sup> Ibid at 257.

<sup>120</sup> Ibid at 258.

environment, directors are expected to steer the strategic direction of the company in a socially responsible manner.<sup>121</sup> This means under the stakeholder theory, companies are required to re-examine their profit-driven priorities by considering the broader context in which the company operates.<sup>122</sup>

This approach of managing corporate affairs consequently amounts to an equilibrium of economic and social goals by the company and is known as the triple bottom line.<sup>123</sup> In terms of the triple bottom line, companies are required to incorporate three pillars of development (economic, social and environmental) into its business strategy in the pursuit of profit maximization.<sup>124</sup>

The most notable debate regarding the imposition of social responsibility onto companies took place between Berle<sup>125</sup> and Dodd.<sup>126</sup> The discussions that brought this debate to prominence were ignited when the basic perception of the company changed.<sup>127</sup> Berle, basing his argument on trusteeship, contended that since the shareholders are the owners of the company, its affairs should be conducted in such a manner that maximises their wealth.<sup>128</sup> Conversely, Dodd argued that the resources of the company should be used to address wider societal concerns.<sup>129</sup> By 1942, both scholars acknowledged the legitimate interests of both shareholders and non-shareholder constituencies.<sup>130</sup>

### 2.3.1 *The Justifications for the Stakeholder Theory*

Due to the interdependencies which companies create, directors should be concerned with striking a balance between economic and social goals and running the company for the benefit of all stakeholders and not merely those of the shareholders.<sup>131</sup> The alignment of the interests

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<sup>121</sup> Ibid.

<sup>122</sup> Ibid.

<sup>123</sup> Op Cite note 47 at 26.

<sup>124</sup> Ibid.

<sup>125</sup> Adolf Berle 'For Whom Corporate Managers are Trustees: A Note' (1932) 45 *Harvard Law Review* 1365-1372.

<sup>126</sup> Merrick Dodd 'For Whom are Corporate Managers Trustees?' (1932) 45 *Harvard Law Review*

<sup>127</sup> Op cite note 4 at 4.

<sup>128</sup> Op cite note 127.

<sup>129</sup> Op cite note 128.

<sup>130</sup> Irene-Marie Esser *Recognition of various stakeholder interests in company management* LLD thesis, University of South Africa at 22.

<sup>131</sup> Brian Cheffins, *Company Law: Theory, Structure and Operation* (1997) chapter 3, at 151-53, chapter 13, at 574-601. Also see Richard Smerdon: *A Practical Guide to Corporate Governance* 4 ed (1998), chapter 1, at 6-10.

of individuals, companies, and society suggests that maximizing shareholder value is not the only legitimate mission of a corporation and it holds, in effect, that companies ought to be governed and controlled with the contribution of, and for the benefit of, all stakeholders including the community at large.<sup>132</sup>

The symbiotic relationship between a company and the social realm within which it operates demands of directors to conduct the affairs of the company in a manner that is conducive for meeting present operational requirements, but without compromising the ability of future generations to meet their needs.<sup>133</sup> The recognition of the interests of the wider range of constituents, and not only those of the shareholders, has an impact on the commercial viability of companies.

When the interests of the shareholders are made the sole focus of corporate governance, the performance of a company will be measured only by the benefits which accrue to shareholders. A probable consequence of this may be the negation of the interests of non-shareholder constituencies.

### 2.3.2 *The Shortcomings of the Stakeholder Theory*

The stakeholder theory has been criticised for its lack of precision, the absence of an enforcement mechanism, and on issues regarding how to weigh and balance the various stakeholder interests that may sometimes be at odds with one another.

Keay argues that the recognition of various stakeholder interests may serve as fertile grounds for the roots of opportunistic behaviour on the part of directors.<sup>134</sup> Such opportunistic behaviour may be used as an attempt to defend fraudulent decisions taken in the name of stakeholders.<sup>135</sup>

Another shortcoming of the stakeholder theory pertains to its enforceability. In 1932, Berle noted that the abandonment of the shareholder primacy theory will only be feasible if it is replaced with a clear and reasonably enforceable scheme of responsibilities to non-shareholder constituencies.<sup>136</sup> As such, a major problem with the stakeholder theory concerns

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<sup>132</sup> Ibid.

<sup>133</sup> Samuel Idowu 'Corporate Social Responsibility: A Capitalist Ideology?' (2012) 1 *International Journal of Entrepreneurship and Innovation* 3 at 244. Also see International Labour Organisation *Decent Work and the 2030 Agenda for Sustainable Development* (2015) at 2.

<sup>134</sup> Andrew Keay 'The Ultimate Objective of the Company and the Enforcement of the Entity Maximisation and Sustainability Model' (2010) 10 *Journal of Corporate Law Studies* at 43.

<sup>135</sup> Ibid.

<sup>136</sup> Op cite note 125 at 1365.

the enforcement of fiduciary duties.

Mongalo correctly submits that under the stakeholder theory, the extension of fiduciary duties to non-shareholder constituencies means that a breach thereof can only be remedied by instituting derivative action proceedings (subject to certain limitations).<sup>137</sup> This assertion is true because the company maintains its separate legal personality. Thus even under the stakeholder theory, the fiduciary duties can only be owed to the company and the company alone.<sup>138</sup>

Be that as it may, employees are arguably the only non-shareholder constituency that can enforce the rights afforded by the stakeholder theory in the Companies Act. This is because section 165 of the Companies Act indirectly extends legal standing to employees by permitting a trade union or another employee representative to institute derivative action proceedings.

To commence with a derivative action a minority shareholder/s or another stakeholder/s needs to serve a demand on a company to protect the legal interests of the company or to continue legal proceedings. Be that as it may, the right to institute the derivative action suit can (arguably) also be extended to other non-shareholder constituencies provided that a legal interest is proved.

Concerning the issue of achieving an equilibrium of stakeholder interests, the greatest challenge would be to ascertain which stakeholder interests should receive priority when the opportunity presents itself. This situation may arise considering that the various interests of different stakeholders may be at loggerheads. Accordingly, such a situation would warrant a judgement call by the members of the SEC. However, this will depend if the company a SEC or if it has been exempted by the Tribunal. And if the company is exempted by the Tribunal or if the company does not have such a committee that performs similar substantive functions like those of the SEC, the board of directors will have to make the said judgement call.

In this regard, Esser proposes a ‘merry-go-round theory’ in terms of which the company is represented by the various stakeholder interests.<sup>139</sup> According to Esser, the various stakeholder’s interests will have different weightings and ‘an interest that may be primary at one particular moment in the company’s existence may become secondary at a later stage’.<sup>140</sup> Esser submits further that the weighting to be attached to a particular stakeholder’s interest will

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<sup>137</sup> Op cite note 108 at 50.

<sup>138</sup> Ibid.

<sup>139</sup> Op cite note 130 at 38-39. Also see generally Irene-Marie Esser and Jean Du Plessis ‘The Stakeholder Debate and Director’s Fiduciary duties’ (2007) 19 SA Merc LJ 358-362.

<sup>140</sup> Ibid

depend on the extent of protection offered in other statutes<sup>141</sup> such as the Labour Relations Act 66 of 1995 and the National Environmental Management Act 107 of 1998.

As such it is submitted that Esser's 'merry-go-round' theory (as expressly advocated for in King IV) may serve a useful step in the right direction and can prove to be a useful tool for members of the SEC.<sup>142</sup> On that note, it is further submitted that the 'merry-go-round' theory coupled with the derivative action proceedings<sup>143</sup> may provide a viable mechanism that can be enforced to advance the protection of non-shareholder constituencies under section 72(4) of the Companies Act.

#### *2.4 The Enlightened Shareholder Value Theory*

As mentioned previously, the enlightened shareholder value approach is a variant of the shareholder primacy theory and the stakeholder theory. The enlightened shareholder value theory was formulated by the Company Law Review Steering Group (CLRSG); a committee commissioned by the United Kingdom's Department of Trade and Industry to oversee its company law reform process.

The essence of the enlightened shareholder value theory embodied in section 172 of the United Kingdom Companies Act 2006 which came into operation in October 2007.<sup>144</sup>

The enlightened shareholder value theory is predicated on the act of balancing the interests of various non-shareholder constituencies with the long-term view of benefiting the shareholders of the company.<sup>145</sup> In terms of this theory, it is permissible for directors to take into account the interests of non-shareholder constituencies in the discharge of their duties, provided that it is in the best interests of the company to do so.<sup>146</sup> Accordingly, the enlightened shareholder value theory recognises and seeks to protect non-shareholder constituencies, albeit rather restrictively.

Under the enlightened shareholder value theory, a decision taken by the directors to benefit non-shareholder constituencies will have to be justified on the basis that it also benefits

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<sup>141</sup> Irene-Marie Esser 'Corporate Social Responsibility: A Company Law Perspective' (2011) 23 *South African Mercantile Law Journal* at 323.

<sup>142</sup> King IV at 26.

<sup>143</sup> Op cite note 139.

<sup>144</sup> This aspect will be unpacked in chapter 4 of this thesis.

<sup>145</sup> John Armour, Simon Deakin & Suzanne Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41 *British Journal of Industrial Relations* 531 at 537.

<sup>146</sup> Ibid.

the shareholders.<sup>147</sup> And while the fiduciary duties of directors are still owed to the company under the enlightened shareholder value theory, this theory makes room for directors to consider the interests of non-shareholder constituencies without risking a breach of their fiduciary duties to the shareholders.<sup>148</sup>

#### 2.4.1 *The Shortcomings of the Enlightened Shareholder Value Approach*

The enlightened shareholder value theory does not embody a radical departure from the shareholder primacy norm because, as its name suggests, it is rooted within the shareholder primacy theory.<sup>149</sup> According to Mongalo, while the enlightened shareholder value theory represents a significant development, its close ties to the shareholder primacy theory render it inadequate to protect non-shareholder constituencies.<sup>150</sup> As such even though the enlightened shareholder value theory advocates for the recognition of non-shareholder constituency interests, the interests of shareholders enjoy exclusive protection.<sup>151</sup>

It thus follows that under the enlightened shareholder value theory, the recognition of non-shareholder constituency interests is merely instrumental in advancing the interests of the shareholders in the long-term. Expressed differently, in terms of the enlightened shareholder value theory, the interests of non-shareholder constituencies are merely recognised and not protected. As such, there is no direct responsibility on members of the SEC to have regard to the interests of non-shareholder constituencies because the members remain to be accountable to the shareholders.

The enlightened shareholder value approach does not extend fiduciary duties to non-shareholder constituencies because they are still owed to the company and consequently the shareholders as interpreted in *Hutton v West Cork Railway*.<sup>152</sup> This is by far the greatest flaw of the enlightened shareholder value theory because the pro-active consideration of non-shareholder constituency interests is not accompanied by an enforcement mechanism to remedy the company's failure to consider their interests.<sup>153</sup>

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<sup>147</sup> Virginia Ho, 'Enlightened Shareholder Value: Corporate Governance Beyond the Shareholder-Stakeholder Divide' (2010) 36 *Journal of Corporation Law* 1 at 78-79.

<sup>148</sup> Ibid.

<sup>149</sup> Ibid.

<sup>150</sup> Op cite note 108 at 46-48.

<sup>151</sup> Ibid.

<sup>152</sup> In *Hutton v West Cork Railway Co* (1883) 23 Ch D at 673 the court held that "[t]he law *does not say that there are to be no cakes and ale*, but there are to be no cakes and ale except such as required for the benefit of the company".

<sup>153</sup> Op cite note 146.



For a corporate governance model to be effective to advance the protection of non-shareholder constituency interests, there must be an enforcement mechanism that guarantees a remedy for a breach of duty.<sup>154</sup> And although section 7 read in conjunction with section 72(4) of the Companies implicitly imposes a duty on directors to consider and protect non-shareholder constituencies, the prospects of successfully enforcing an implicit duty seems unlikely.<sup>155</sup>

## 2.5 *The Position in South Africa*

The legal recognition of non-shareholder constituencies in South Africa is provided by partly mandatory and partly voluntary legal instruments.<sup>156</sup> The Companies Act regulates the mandatory position whereas the King Reports on Good Corporate Governance in South Africa contain important recommendations regarding the protection and recognition of non-shareholder constituencies although its application is limited to companies listed on the Johannesburg Stock Exchange (JSE).<sup>157</sup> The next part of this chapter analyses the theory adopted in South Africa's mandatory and voluntary corporate law regime.

### 2.5.1 *The Emergence of the Enlightened Shareholder Value Theory in South Africa*

In 2004, the Department of Trade and Industry (DTI) published a policy document which facilitated the reform process of South Africa's company law regime. The need for reform was necessitated by the recognition of the interdependencies of companies and the social realm within which they operate.<sup>158</sup> The failures of companies in other countries also contributed to the need for higher standards of corporate governance, ethics, transparency, and accountability of companies.<sup>159</sup> As such, these fundamental changes and events underscored the need for the adoption of a new Companies Act that was reflective of the country's economic, social and

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<sup>154</sup> Op cite note 134 at 36.

<sup>155</sup> My emphasis.

<sup>156</sup> Irene-Marie Esser and Piet Delport 'Shareholder Protection Philosophy in Terms of the Companies Act 71 of 2008' (2016) 79 *THRHR* 1 at 1-2.

<sup>157</sup> Ibid.

<sup>158</sup> The Department of Trade and Industry *South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Law Reform* GN 1183 in GG 2649 of 23 June 2004 at 13-14.

<sup>159</sup> The failure of some the biggest companies in America such as Enron and WorldCom firmly placed unscrupulous profit maximization by directors into the spotlight and unveiled serious unethical practises associated with the governance of companies. See generally, Joseph Heath and Wayne Norman 'Stakeholder Theory, Corporate Governance and Public Management: What can the History of State-run Enterprises Teach us in the Post-Enron Era?' (2004) 53 *Journal of Business Ethics* 3

political transition to a new democratic dispensation.<sup>160</sup>

To a large degree, the reform process was motivated by the need to enact a new Companies Act that would align with the principles of fairness and equality espoused in the South African Constitution as the supreme law of the country.<sup>161</sup> It was also necessary to enact a new companies Act that was consistent with other pieces of legislation such as the Employment Equity Act<sup>162</sup> and the various environmental regulations<sup>163</sup> which echo the spirit of the Constitution of the Republic of South Africa.<sup>164</sup>

The DTI recommended the enlightened shareholder value theory as the theoretical foundation of the new Companies Act<sup>165</sup> and consequently the SEC. According to the DTI, the adoption of the enlightened shareholder value approach would only necessitate minuscule reform since the approach is not dependent on any change in the ultimate objective of companies, that is, shareholder wealth maximisation.<sup>166</sup>

Thus in light of South Africa's unique context, the DTI considered the adoption of the enlightened shareholder value theory as the best philosophical foundation for the Companies Act, the citizens of South Africa and to give effect to the mandate of the Constitution.<sup>167</sup> The DTI also considered this theory to be the best way to protect the inflow of shareholder investment (Foreign Direct Investment) into the country because the shareholders may be hesitant to address socio-economic issues unless they are doing it under the guise of shareholder primacy theory.<sup>168</sup>

### 2.5.2 *The Companies Act 71 of 2008.*

Following the issue and publication of the policy document and the subsequent draft Companies Bill which was published in 2008 by the DTI, the Companies Act of 2008 and Companies Regulations, 2011 came into force on 1 May 2011.

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<sup>160</sup> Ibid.

<sup>161</sup> Ibid.

<sup>162</sup> Act 55 of 1998.

<sup>163</sup> See, *inter alia*, the National Environmental Management Act (Act 107 of 1998) and the National Environmental Management: Air Quality Bill, 2003.

<sup>164</sup> Op cite note 158.

<sup>165</sup> The DTI opted for the enlightened shareholder value approach by stating that 'a company should have as its objective the conduct of business activities with a view to enhancing the economic success of the corporation, taking into account, as appropriate, the legitimate interests of other stakeholder constituencies'. See op cite note 158 at 25-26.

<sup>166</sup> Op cite note 158 at 25-26.

<sup>167</sup> Ibid.

<sup>168</sup> Ibid.

Unlike its predecessors, the Companies Act arguably echoes a slight deviation from the traditional and narrow interpretation of the term ‘best interests of the company’.<sup>169</sup> However, Esser opines that the wording in section 76(3)(b) could have been clearer because the current wording of this provision creates the impression that shareholder primacy has been retained.<sup>170</sup> According to Stoop, the Companies Act does not provide an amendment of the phrase ‘best interests of the company’ and as such, the phrase will remain to be interpreted as the collective interests of shareholders.<sup>171</sup>

It is submitted that the practical difficulties associated with interpreting the notion of ‘best interests of the company’ in a manner that enhances the social welfare considerations of companies gravely undermine the ability of the SEC to address issues of national priority and the concomitant protection of non-shareholder constituency interests.

To truly give effect to section 5(1) of the Companies Act, the interpretation of section 7(d) may demand a wider meaning to the phrase ‘best interests of the company’ to include non-shareholder constituencies.<sup>172</sup>

Based on the analysis above, the theory adopted in the Companies Act is unclear but it appears that the foundation of the Companies Act as a whole (and consequently the SEC) is one that is “in-between” the shareholder primacy theory and enlightened shareholder value theory.<sup>173</sup>

This is because there is no formal legal recognition of non-shareholder constituencies in the Act. The only echoes of the enlightened shareholder value approach are to be found in section 72(4) read with Regulation 43 which mentions that one of the functions of the SEC is to monitor how the company’s activities affect non-shareholder constituencies. Other echoes of the enlightened shareholder value theory can be found in the remedial provision contained in section 218(2) which gives stakeholders some right of recourse in the event where the provisions of the Companies Act are contravened.<sup>174</sup>

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<sup>169</sup> Op cite note 9 at 580-581.

<sup>170</sup> Op cite note 141 at 324.

<sup>171</sup> Op cite note 159.

<sup>172</sup> Sulette Lombard and Tronel Joubert ‘The Legislative Response to the Shareholders and Stakeholders Debate: A Comparative Overview’ (2014) 14 *Journal of Corporate Law Studies* 1 at 221.

<sup>173</sup> Rehena Cassim and Forouk Cassim, ‘The Reform of Corporate Law in South Africa’ (2005) 16 *International Company and Commercial Law Review* at 411-412.

<sup>174</sup> In order for shareholder to succeed in such a claim against the directors or auditors of the company they must prove a loss. See: *Hlumisa Investment Holdings (RF) Limited and Another v Kirkinis and Others* (100390/2015) [2018] ZAGPPHC 676; 2019 (4) SA 569 (GP).

However, it is arguable whether section 72(4) read with Regulation 43 and section 218(2)<sup>175</sup> do indeed echo the enlightened shareholder value theory considering that the requirement to monitor non-shareholder constituencies is different from the prescript to legally recognise or to take their interests into account. Thus it follows that the theory adopted in the Companies Act is not in line with the recommendations made in the DTI policy document.

Because of the adoption of this “in-between” approach, the theoretical underpinning of the SEC is in part the reason why section 72(4) is not a viable mechanism that can be enforced to ensure the protection of non-shareholder constituencies. Accordingly, it shall suffice to say that shareholder primacy has been retained in South Africa’s mandatory corporate law regime because the SEC’s prescript to monitor non-shareholder constituencies does not place a *sui generis* duty on directors. The duty to act in the best interests of the company is still owed to the shareholders in South Africa’s mandatory corporate law regime.

### 2.5.3 *The King Codes on Corporate Governance in South Africa*

In South Africa, the benchmark for good corporate governance is encompassed in the King Reports on Corporate Governance. To date, the King committee has published four codes of good practice to be adopted voluntarily by companies and other institutions operating in South Africa. However as mentioned before, the JSE makes it mandatory for listed companies to apply the recommendations of King the code if they are to maintain their listing on the JSE.<sup>176</sup>

The first King Report, King I, was published in 1994 and advocated for effective communication with stakeholders.<sup>177</sup> The King I Report recognised the importance of effective communication as a means of facilitating stakeholder protection.

The King II report built on the approach adopted in the first King report and acknowledged the shift from a single bottom line approach to a triple bottom line approach.<sup>178</sup>

The publication of the King III report, which came into effect in 2009, was necessitated by the enactment of the new Companies Act 71 of 2008.<sup>179</sup>

Due to the significant corporate governance and regulatory developments locally and

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<sup>175</sup> Section 218(2) arguably echoes the enlightened shareholder value approach in that it may be invoked by any person who contends that the directors failed to monitor how the operations of the company impacted non-shareholder constituencies.

<sup>176</sup> Johannesburg Stock Exchange ‘Listings Requirements’ available at <https://www.jse.co.za/listing-process/listing-on-the-jse> accessed on 26 August 2019.

<sup>177</sup> King I Report ch 12 par 17.

<sup>178</sup> See King II par 29 in the introduction. Also see King II Introduction; Executive summary par 17.1

<sup>179</sup> King III Report Introduction and background at 5.

internationally since King III was issued, an update to King IV was necessary.<sup>180</sup> As such, King IV came into effect in 2017.

The foundation of all four King reports is based on ethical and effective leadership. And just like its predecessors, King IV advocates for stakeholder inclusive approach.<sup>181</sup> This philosophical underpinning of King IV represents a stark departure from the shareholder primacy norm. King IV expressly advocates for a stakeholder approach in asserting that ‘adopting the stakeholder-inclusive approach means that the best interests of the company are not necessarily always equated to the best interests of the shareholders’.<sup>182</sup>

The stance adopted in King IV endorses Esser’s recommendation to do away with interpreting the term ‘best interests of the company’ to mean the interests of the shareholders. According to Esser, the traditional interpretation of the term company will remain to be obscured for as long it equates or translates to shareholders.<sup>183</sup>

## 2.6 Chapter Conclusion

The enlightened shareholder value theory and stakeholder theory represent a slight trajectory from a shareholder primacy norm which only sought to be concerned with one corporate constituent, namely the shareholders. The accommodative nature of the enlightened shareholder and stakeholder theories are progressive in that they reflect a holistic attitude towards the management of corporate affairs.

However, the enlightened shareholder value theory is largely reminiscent of the shareholder primacy theory which makes it unworkable and inadequate to protect non-shareholder constituencies. Furthermore, the enlightened shareholder value approach does not extend fiduciary duties to non-shareholder constituencies hence the absence of protection.

In this regard, it was submitted that the stakeholder theory, subject to certain adjustments, may present to be a better and workable philosophical underpinning for the SEC.

This chapter demonstrated that the King Reports on Corporate Governance advocate a stakeholder theory. While an analysis of the Companies Act revealed that its drafters adopted a theory that is “in-between” the shareholder primacy theory and the enlightened shareholder value theory. As such, it was found that the theory adopted in the Companies Act is not in line with the one recommended by the DTI in the policy document.

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<sup>180</sup> Werksmans *A review of the King IV Report on Corporate Governance 2016* at 6.

<sup>181</sup> Op cite note 47 at 25.

<sup>182</sup> Ibid at 26.

<sup>183</sup> Op cite note 130 at 39.

The next chapter will encompass an analysis of the structure and legal status of the SEC to address the categorical ambiguity of the SEC as either a sub-board committee or a separate organ of the company. This will be done to demonstrate how this ambiguity further negates the protection of non-shareholder constituencies.

## CHAPTER 3: THE LEGAL STATUS OF THE SOCIAL AND ETHICS COMMITTEE

### 3.1 INTRODUCTION

Chapter 2 of this dissertation analysed how the philosophical foundation of the SEC negates the presence of a clear and reasonably enforceable scheme of responsibilities to non-shareholder constituencies.<sup>184</sup> This has culminated in the poor drafting of section 72(4) read with Regulation 43.<sup>185</sup> As such, the efficacy of the SEC is further negated by a lack of consensus regarding its appointment by either the board of directors or the shareholders.

The lack of consensus in this regard affects the committee's legal status as either a board committee or a company committee. The ambiguity regarding the appointment of the SEC also affects the enforceability of section 72(4) read with Regulation 43 in that there is much uncertainty regarding which organ of the company is responsible for monitoring how the operations of the company impact non-shareholder constituencies. In this regard, there is also uncertainty regarding which organ of the company accountability can be imputed to.

This chapter will examine the legal status of the SEC by analysing the division of power in a company, and the SEC's capacities and incapacities. This chapter will also provide an overview of the lack of consensus regarding the appointment of the SEC. This analysis is necessary to provide an answer to the research question, namely whether section 72(4) read with Regulation 43 is a legally viable mechanism that can be enforced to protect non-shareholder constituencies.

### *3.2 The Division of Powers in a Company as it Pertains to the Social and Ethics Committee*

As an artificial legal person, a company can only act through a medium of functionaries known as organs.<sup>186</sup> Accordingly, the Companies Act confers the decision making authority, subject to the Act and Memorandum of Incorporation (MOI), on the two principal organs of the company, namely, the board of directors and the shareholders.<sup>187</sup> These two organs execute such conferred authority subject to a decision-making framework in the form of meetings and by delegating authority.<sup>188</sup>

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<sup>184</sup> This was demonstrated in chapter 2.

<sup>185</sup> My emphasis.

<sup>186</sup> Nereus Joubert in Visser and Pretorius (eds) *Essays in honour of Frans Malan: former judge of the supreme court of appeal* at 81.

<sup>187</sup> Jacqueline Yeats, Richard Jooste, and Richard de la Harpe *Commentary on the Companies Act* 2ed (2018) at 2-1249.

<sup>188</sup> Ibid.

Thus, the relationship between the directors and shareholders is governed by a division of power because section 66 of the Companies Act explicitly divides powers between the shareholders in the general meeting on one hand and the board of directors on the other hand.<sup>189</sup>

To briefly outline this relationship, directors have an unfettered discretion to manage the business of the company and no shareholder may interfere with the board in doing so.<sup>190</sup> And although shareholders may not interfere in the management of the company, they appoint<sup>191</sup> and they may dismiss directors.<sup>192</sup> Accordingly, shareholders do not have the right to manage the business and affairs of the company.<sup>193</sup> Thus, it follows that the business and affairs of the company must be managed by or under the direction of the directors.<sup>194</sup> This, in turn, means that the ultimate power rests with the board of directors and not the shareholders unless indicated otherwise in the Act or the MOI.<sup>195</sup>

The division of powers in a company is important as it determines the powers and functions of the organs of the company.<sup>196</sup> And in the context of the SEC, it determines which organ of the company is responsible for monitoring the impact of the company's operations on non-shareholder constituencies and the basis upon which liability can be attributed.<sup>197</sup>

### 3.3 *The Lack of Consensus Regarding the Legal Status of the Social and Ethics Committee*

The lack of consensus regarding the appointment of the SEC arguably stems from nuances in Regulation 43.<sup>198</sup> In terms of Regulation 43(2), reference is made to circumstances in which a *company* need not appoint an SEC. However, in terms of Regulation 43(3), reference is made to circumstances in which a *board of directors* is required to appoint an SEC. As such, it is

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<sup>189</sup> This position is however flexible in that the default position applies to the extent which the Companies Act or a company's MOI provides otherwise. See op cite 90 at 48.

<sup>190</sup> *Francis George Hill Family Trust v South African Reserve Bank* 1992 (3) SA 91 (A) at 97.

<sup>191</sup> Section 67 of the Companies Act.

<sup>192</sup> It is important to note that the right conferred on shareholders by section 71(1) to remove directors only applies to those shareholders who are entitled to exercise voting rights in an election of that director.

<sup>193</sup> Further to that, shareholders do not have the authority to contract with third parties. See Op cite note 95 at 39. Also see *Francis George Hill Family Trust v South African Reserve Bank* 1992 (3) SA 91 (A) at 97.

<sup>194</sup> Section 66 of the Companies Act. Although section 66 confers to the board of directors the highest decision-making authority, the ambit of control that can be exercised by the shareholders is not clear. See op cite note 186 at 91.

<sup>195</sup> *Navigator Property Investments (Pty) Ltd v Silver Lakes Crossing Shopping Centre (Pty) Ltd* [2014] JOL 32101 (WCC) at para 31. Also see op cite note 89 at 47.

<sup>196</sup> Op cite note 186 at 84.

<sup>197</sup> My emphasis.

<sup>198</sup> My emphasis.



submitted that the difference in the wording used in Regulation 43 to refer to the *company* in one instance and then referring to the *board of directors* in another instance creates much uncertainty regarding the appointment of the SEC.

As a result, this ambiguity has led to a difference in opinion by various commentators regarding its appointment. According to Joubert, the SEC is a board committee based on the short title and overall context of section 72 of the Companies Act.<sup>199</sup> Locke also categorises the SEC as a board committee by submitting that Regulation 43(2) and Regulation 43(3) must be read together to mean that the board of directors has the power to appoint the members of the SEC.<sup>200</sup> As such, Rossouw submits that the best way to reconcile the nuances in the Regulations is for the company to categorise the SEC as a board committee by passing a resolution to that effect at the company's first annual general meeting.<sup>201</sup>

In *Henochsberg*, it is argued that the SEC is a company committee because even though the reference in section 72 provides for *board* committees, in respect of the SEC, the references are that the *company* must appoint it.<sup>202</sup>

Stoop points out that the Companies and Intellectual Property Commission's (Commission) intervention to convene a general meeting of shareholders in an instance where a company fails to appoint an SEC is indicative of the fact that it is a company committee.<sup>203</sup> However, Stoop mentions further that such intervention by the Commission may be necessary to assert the shareholder's common law right to override an unresponsive board of directors.<sup>204</sup>

Esser and Delport are of the view that the SEC is a company committee because its discretion to be heard at a general shareholders meeting encapsulated in section 72(8)(e) is wider than its responsibility to draw the board's attention to certain matters in terms of in Regulation 43(5)(c).<sup>205</sup>

In this regard, Bouwman submits that the SEC's discretion to report to the shareholders at a general meeting is merely aimed at enhancing disclosure and transparency and has no bearing on the SEC's accountability to the board.<sup>206</sup>

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<sup>199</sup> Op cite note 38 at 229.

<sup>200</sup> Natania Locke *Enhanced Accountability* in Michele Havenga & Irene-Marie Esser (eds) *Corporate Governance Review* (2012) at 109.

<sup>201</sup> Op cite note 39 at 22.

<sup>202</sup> Piet Delport, Quintus Vorster and David Burdette *Henochsberg on the Companies Act 71 of 2008* 1st ed (2011) at 227.

<sup>203</sup> Op cite note 9 at 577.

<sup>204</sup> Ibid.

<sup>205</sup> Op cite 37 at 224.

<sup>206</sup> Natasha Bouwman 'The Social and Ethics Committee' (2011) 9 *Without Prejudice* 11 at 32.

Based on the analysis above, it is submitted that the legal status of the SEC is a gray area in the law because there is uncertainty regarding which organ of the company is responsible for its appointment. The appointment of the SEC in Regulation 43 is not set out consistently and lacks clearly defined requirements. This is because the provisions setting out its appointment contains mixed characteristics of both organs of the company in that Regulation 43 refers to both the shareholders and the board of directors regarding the appointment of the SEC.

### *3.4 The Importance of Making the Correct Categorisation of the Social and Ethics Committee's Legal Status*

The arguments which have been advanced to support the categorisation of the SEC as either a board committee or company committee are all credible. However, it is unfortunate that between the Act and Regulations, neither provide any conclusive answers regarding its appointment.<sup>207</sup>

Nonetheless, whichever approach is followed has to be in line with the purposes set out in section 7(d) of the Companies Act, namely to 'reaffirm the concept of the company as a vehicle for achieving social and economic benefits for the people of South Africa'.<sup>208</sup>

As such, it is important to provide a conclusive answer because if the SEC is categorised as a board committee, its members will be subject to fiduciary and statutory duties.<sup>209</sup> However, if the SEC is categorised as a company committee, it will only be subject to the functions and powers stated in section 72(4) read with Regulation 43.<sup>210</sup> Furthermore, the correct classification of the SEC is important to determine the type of relationship between it and the shareholders.<sup>211</sup>

### *3.5 The Correct Understanding of the Social and Ethics Committee's Legal Status*

As demonstrated above, an analysis of section 72(4) read with Regulation 43 can be construed to mean that the SEC can be categorised as either a board committee or a company committee. Section 158(b(ii)) of the Companies Act provides that if a provision in the Act can be interpreted to have more than one meaning, the meaning which promotes the spirit and purposes of the Act

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<sup>207</sup> My emphasis.

<sup>208</sup> My emphasis.

<sup>209</sup> Op cite at 37 at 229.

<sup>210</sup> Ibid.

<sup>211</sup> Ibid.

must be preferred.

As such, based on the short title of section 72 and the overall context of Regulation 43, it is submitted that the SEC is a board committee.<sup>212</sup> This is the interpretation which best promotes the purposes of the Companies Act espoused in section 5(1) read in conjunction with section 7; namely to comply with the provisions of the Bill of rights contained in the Constitution and to align the objectives of a company within the social realm in which it operates.<sup>213</sup>

As a board committee, the SEC will be subject to the common law fiduciary duties and statutory duties and these duties are thrust on non-director members of the SEC even if they do not have decision-making powers.<sup>214</sup> The common law and statutory fiduciary duties also extend equally to non-executive directors and executive directors who comprise the SEC in terms of Regulation 43(4).

Legally, there is no difference between executive and non-executive. It is an established practice, however, to classify directors according to their different roles on the board of directors. Executive directors are involved in the general day-to-day management of the company and usually serve on the board of directors as full-time salaried employees of the company.<sup>215</sup> Non-executive directors, on the other hand, are not involved in the day-to-day management of the company.<sup>216</sup> Despite the distinction between executive and non-executive directors drawn in practice, legally they all remain equally and collectively accountable for the board's actions and decisions.<sup>217</sup>

However, as demonstrated in Chapter 2, these fiduciary duties are not owed to non-shareholder constituencies because the phrase 'best interests of the company' remains to be exclusively synonymous with the interests of the shareholders.

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<sup>212</sup> This assertion is line with the arguments advanced by Joubert at op cite note 199 and Locke at op cite note 200.

<sup>213</sup> My emphasis.

<sup>214</sup> The rationale for this is that due to the integral role which the SEC plays in the governance of a company and ensuring that CSR objectives are embedded in the core of the company's strategy; '[t]he adages are no power goes without responsibility and with greater power goes greater responsibility'. See also op cite note 65 at 511.

<sup>215</sup> *Fisheries Development Corporation v Jorgensen and others* 1980 (4) SA 156 (W).

<sup>216</sup> Ibid.

<sup>217</sup> Supra note 52.

### *3.6 The Viability of Section 72(4) Read with Regulation 43 as a Mechanism to Protect the Interests of Non-Shareholder Constituencies.*

While it is submitted in this dissertation that the legal status of the SEC is that of a board committee, it is further submitted that section 72(4) read with Regulation 43 is not a legally viable mechanism that can be enforced to protect the interests of non-shareholder constituencies in the Companies Act.

This is because the phrase ‘best interests of the company’ is still construed to be synonymous with the interests of shareholders and as such, the SEC may only protect the interests of non-shareholder constituencies in as much as they are in line with those of the shareholders.<sup>218</sup>

Be that as it may, a narrow interpretation of section 7(d) could warrant a wider meaning to the phrase ‘best interests of the company’ to include the interests of non-shareholder constituencies.<sup>219</sup> However, since non-shareholder constituencies are not provided with any direct rights or legal recognition in the Companies Act, this remains a matter for judicial interpretation.<sup>220</sup> And unless the common law is either repealed by a competent body or it is declared invalid by a court of law, this phrase will remain to be interpreted as the collective interests of the shareholders.<sup>221</sup>

As such, the current formulation of section 7(d) read in conjunction with section 72(4) and Regulation 43 justifies the conclusion that the protection of non-shareholder constituencies is not sufficiently catered for by the Companies Act.<sup>222</sup>

### *3.7 Chapter Conclusion*

This chapter analysed the uncertainty regarding the legal status of the SEC. It was found that this uncertainty arguably stems from the nuances found in Regulation 43. As a result of these nuances, there has been a lack of consensus in the literature available regarding the appointment of the SEC and consequently its legal status as either a board committee or a company committee.

It was submitted that the SEC is a board committee based on the overall context of

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<sup>218</sup> My emphasis.

<sup>219</sup> Sulette Lombard and Tronel Joubert ‘The legislative response to the shareholders and stakeholders debate: a comparative overview’ (2014) 14 *Journal of Corporate Law Studies* 1 at 221.

<sup>220</sup> Ibid.

<sup>221</sup> Ibid.

<sup>222</sup> My emphasis.

section 72 and Regulation 43. It was also submitted that the SEC is a board committee because this is the interpretation which best promotes the purposes of the Act espoused in section 7(d) of the Companies Act.

Accordingly, the members of the SEC regardless of whether they are directors, non-directors, executive directors or non-executive directors, they're all subject to common law and statutory fiduciary duties. However, these fiduciary duties are not owed to non-shareholder constituencies because the phrase 'best interests of the company' remains to be exclusively synonymous with the interests of the shareholders.

Furthermore, it was found that section 72(4) read with Regulation 43 is not a legally viable mechanism that can be enforced to protect non-shareholder constituency interests. This is because the provision of clarity regarding the legal status of the SEC will not suffice to ensure the protection of non-shareholder constituencies.

The next chapter will provide an analysis of the protection of non-shareholder constituencies in the United States of America and the United Kingdom to determine whether there are any lessons from which South Africa can draw.

## CHAPTER 4: AN OVERVIEW OF NON-SHAREHOLDER CONSTITUENCY PROTECTION IN THE UNITED STATES OF AMERICA AND THE UNITED KINGDOM

### 4.1 INTRODUCTION

The protection of non-shareholder constituencies is a highly contentious topic and one which countries all over the world tackle.<sup>223</sup> On the one hand, Anglo-American countries such as South Africa, the United States of America (USA) and the United Kingdom (UK) have maintained the shareholder primacy theory.<sup>224</sup> While the stakeholder theory is dominant in many continental European countries such as Germany and East Asian countries such as Japan on the other hand.<sup>225</sup>

In the USA the protection of non-shareholder constituencies is provided by legal instruments commonly referred to as constituency statutes.<sup>226</sup> Generally, constituency statutes explicitly permit directors to take non-shareholder constituencies into account during the decision-making process.<sup>227</sup>

In the UK it has been said that section 172 of the Companies Act 2006 (UK Companies Act) arguably encapsulates the enlightened shareholder value theory and places a duty on directors to promote the success of the company whilst having regard to a non-exhaustive list of non-shareholder constituency interests.<sup>228</sup>

This chapter examines and compares the different models of non-shareholder constituency protection in the USA and UK to determine how the protection thereof is enforced. The main objective is to establish whether there are lessons to be drawn from the UK and USA models that may influence corporate law reform in South Africa. The first part of the analysis begins with the position in the US and this will be followed by an examination of the position in the UK.

The rationale behind this comparative approach is twofold. The first being that South Africa, the USA, and the UK are all common law jurisdictions and they also share similar economic and financial market systems.

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<sup>223</sup> Op cite note 32 at 249.

<sup>224</sup> Ibid.

<sup>225</sup> Ibid.

<sup>226</sup> Kathleen Hale 'Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes' (2003) 45 *Arizona Law Review* 3 at 829.

<sup>227</sup> Ibid at 830.

<sup>228</sup> Legislation.gov.uk 'Explanatory notes on the Companies Act 2006' at para 325 available at <http://www.legislation.gov.uk/ukpga/2006/46/notes/division/6/2> (accessed on 2 December 2019).

The second reason is that much of South Africa's corporate law regime is to a large extent premised in English law (and Roman-Dutch law) therefore it forms a significant part of South Africa's common law.

Furthermore, the Model Business Corporation Act (MBCA), the Delaware General Corporation Law (DGCL), the Maryland General Corporation Law (MGCL) and the UK Companies Act of 2006 has played a huge role in the development of the South African Companies Act 71 of 2008.<sup>229</sup> As such, a comparative perspective that analyses how the USA and UK protect non-shareholder constituencies may be necessary for purposes of determining whether there are any lessons from which South Africa could learn.

#### *4.2 The Emergence of Constituency Statutes in the United States of America*

The constituency statutes refer to a part of a State's statutory company law regime that governs the relationship between the company and its stakeholders. These legal instruments constitute a portion of the provisions which deal with the director's duties<sup>230</sup> and the overriding principle in most of them holds that directors owe their fiduciary duties to the company and its shareholders.<sup>231</sup> Thus it follows that the objective of the director's core fiduciaries in the USA was and still is shareholder-centric.<sup>232</sup>

Before the constituency statutes were developed, there was uncertainty regarding whether it was legally permissible for directors to consider the interests of non-shareholder constituencies in their decision-making.<sup>233</sup> In this regard, constituency statutes provide stability to inconsistent case law by expressly permitting directors to consider interests beyond those of the shareholders.<sup>234</sup>

Constituency statutes have been enacted in most American states and generally permit directors to take non-shareholder constituency interests into account without breaching their fiduciary duties.<sup>235</sup> The first constituency statute was passed in Pennsylvania in 1983.<sup>236</sup> Since then, constituency statutes have been enacted in over 40 American States with the notable

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<sup>229</sup> Op cite note 108 at 20-21.

<sup>230</sup> Steven Wallman 'The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties' (1991) 21 *Stetson Law Review* 1 at 166.

<sup>231</sup> Ibid.

<sup>232</sup> Rima Fawal Hartman, 'Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals' (1993) 50 *Washington and Lee Law Review* 4 at 1768.

<sup>233</sup> Op cite note 226 at 829.

<sup>234</sup> Ibid at 830.

<sup>235</sup> Ibid at 832.

<sup>236</sup> Ibid at 833.

exception of Delaware.<sup>237</sup>

Hale observes that constituency statutes were enacted as a response to the hostile takeovers which rocked the corporate landscape in America during the 1980s.<sup>238</sup> A takeover happens when a company (“the acquiring company”) makes a bid to the directors of another company (the target company) to buy it and both parties agree to the terms and conditions of the transaction.<sup>239</sup> This situation becomes hostile when the bid is made despite objections from the board of directors.<sup>240</sup>

Back in the 1980s, takeovers were popular because shareholders stood to benefit from the transaction as the bidding price was usually well over the share price compared to when the shareholders initially invested in the company.<sup>241</sup> As such, directors were compelled to accept a handsome bid that was higher than the current market price of the company’s shares otherwise they risked breaching their legal duty to maximise shareholder wealth.<sup>242</sup>

The financial windfalls from takeover bids benefitted shareholders even though non-shareholder constituencies suffered deleteriously.<sup>243</sup> These hostile takeover era was blamed for extensive job losses and ruining the company’s relationships with its suppliers and customers.<sup>244</sup> The hostile takeover were also blamed for the decimation of communities as they generally resulted in lost charitable and social donations from which communities benefitted when companies operated in their hometowns.<sup>245</sup>

As a consequence of the adverse effects which the takeovers had on non-shareholder constituencies, some states enacted constituency statutes to provide directors with a “legal tool” to oppose a takeover.<sup>246</sup> Constituency statutes were thus developed as tools for directors to reject a takeover bid rather than as tools to empower non-shareholder constituencies.<sup>247</sup>

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<sup>237</sup> Andrew Keay ‘Moving towards Stakeholderism? Enlightened Shareholder Value, Constituency Statutes and More: Much Ado about Little?’ (2011) *European Business Law Review* at 8.

<sup>238</sup> Op cite note 226 at 831.

<sup>239</sup> Anderi Shleifer and Robert Vishny ‘The Takeover Wave of the 1980s’ (1990) 249 *Jstor* 4970 at 745.

<sup>240</sup> Ibid.

<sup>241</sup> Op cite note 226.

<sup>242</sup> Ibid.

<sup>243</sup> Ibid

<sup>244</sup> Ibid.

<sup>245</sup> Steven Rosenblum, ‘Proxy Reform, Takeovers, and Corporate Control: The Need for a New Orientation’, 17 J. CORP. LAW at 204.

<sup>246</sup> Op cite note 236 at 10.

<sup>247</sup> Martin Lipton ‘Takeover Bids in the Target's Boardroom’ (1979) 35 *Business Lawyer* 101. See also op cite note 108 at 109.



Accordingly, certain states such as Iowa, Louisiana, Missouri, Oregon, Rhode Island, and Tennessee limit the application of constituency statutes to takeover scenarios, however, a majority of the constituency statutes in other states do not have this limited scope of applicability.<sup>248</sup>

Notably in Delaware, the state in which the majority of companies are incorporated in the USA, the legislature has not enacted a constituency statute.<sup>249</sup> This is perhaps the reason why South Africa is still shareholder-centric considering that its company law is largely influenced by the Delaware Corporate regime.

#### *4.3 The Constituency Statutes Vary Across the Different American States*

The states that have enacted constituency statutes generally follow a similar pattern with a unifying principle that permits directors to consider non-shareholder constituency interests.<sup>250</sup> However, there are important variations in the constituency statutes amongst the various states that relate to several issues such as whether shareholder interests trump non-shareholder constituency interests.<sup>251</sup> Another variation concerns whether permission to consider non-shareholder constituency interests are extended to the board of directors or a committee of the board.<sup>252</sup> The final variation that will be analysed in this dissertation pertains to whether the consideration of non-shareholder constituencies is discretionary or mandatory.<sup>253</sup>

It is important to highlight how the constituency statutes vary across the states to provide a framework for their analysis and to examine the similarities and differences between the South African and American models. A critical analysis of all the variations is, however, beyond the scope of this dissertation.

##### *4.3.1 The Primacy of Stakeholder Interests*

The first variation concerns whether shareholder interests are to be given primacy over non-shareholder constituency interests. This issue goes to the heart of the shareholder-stakeholder debate because it addresses the objective of the company and it seeks to establish the

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<sup>248</sup> Ibid.

<sup>249</sup> Op cite note 226 at 833.

<sup>250</sup> Nathan Standley 'Lessons Learned from the Capitulation of the Constituency Statute' (2012) 4 *Elon Law Review* 2 at 212.

<sup>251</sup> Jonathan Springer 'Corporate Constituency Statutes: Hollow Hopes and False Fears' (1999) *Annual Survey of American Law* 1 at 97.

<sup>252</sup> James J Hanks Jr 'Playing With Fire: Non-shareholder Constituency Statues in the 1990s' (1991) 21 *Stetson Law Review* 1 at 103.

<sup>253</sup> Op cite note 250.

beneficiaries of fiduciary duties.<sup>254</sup>

Delaware law is arguably the leading authority in the development of corporate law and is looked to by other American states to determine the extent of the director's fiduciary duties.<sup>255</sup> Delaware case law primarily from the mid-1980's maintained that fiduciary duties are owed exclusively to the company and the shareholders collectively.<sup>256</sup> In *Smith v. Van Gorkom*, the Supreme Court of Delaware determined that 'in carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders'.<sup>257</sup> Later that same year, the same court in *Unocal Corp. v. Mesa Petroleum Co* permitted directors to consider non-shareholder constituency interests for the first time albeit in takeover circumstances.<sup>258</sup>

Following the two cases mentioned above, in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc*, the Supreme Court of Delaware stated that the consideration of non-shareholder constituencies must be rationally connected to the shareholder's interests.<sup>259</sup> Put differently, the court determined that non-shareholder constituency interests have to be concurrent with shareholder interests.

Although the cases mentioned above were decided in a takeover context, a fundamental tenet of Delaware common law was and still is shareholder primacy.<sup>260</sup> In this regard, constituency statutes do not represent a radical departure from the shareholder primacy norm however, it appears that they do erode the shareholder primacy norm by expressly permitting directors to consider non-shareholder constituencies.<sup>261</sup> Further to this, there is no provision in the constituency statutes that provides that the directors fiduciary duties are owed exclusively to shareholder interests.<sup>262</sup>

To demonstrate, Indiana's statute expressly provides that 'directors are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor'.<sup>263</sup> Further to this, the Indiana statute also

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<sup>254</sup> This was demonstrated in chapter 2 of this thesis.

<sup>255</sup> Op cite note 250 at 222.

<sup>256</sup> Ibid.

<sup>257</sup> *Smith v. Van Gorkom* 488 A.2d 858 (Del. 1985) at 872.

<sup>258</sup> *Unocal Corp. v. Mesa Petroleum* 493 A.2d 946 (Del. 1985) at 955.

<sup>259</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc* 506 A.2d 173 (Del. 1986) at 176.

<sup>260</sup> Op cite note 237 at 61.

<sup>261</sup> Andrew Keay 'Tackling the Issue of Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach' (2007) 29 *Sydney Law Review* 4 at 581.

<sup>262</sup> Op cite note 230 at 166.

<sup>263</sup> IN ST 23-1-35-1 (f).

expressly rejects the Delaware judicial precedents (presumably laid out in *Unocal Corp. v. Mesa Petroleum Co* and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc*) which advance shareholder primacy and profit maximization in a takeover context.<sup>264</sup>

In the US, it appears to be settled that non-shareholder constituency interests may be taken into account insofar as they are concurrent with shareholder interests.<sup>265</sup> Thus it appears that the US position leans more towards an enlightened shareholder value approach albeit in a shareholder centric space.

In South Africa on the other hand, non-shareholder constituencies have not received formal recognition in the Companies Act because there is no statutory pronouncement on the issue.<sup>266</sup> However, there are various provisions in the Companies Act such as Section 5 read with section 7 and section 72(4) which arguably advocate for a stakeholder inclusive approach.

Further to this, in *Stilfontein Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd*<sup>267</sup>, Hussien J found that non-compliance with the principles entrenched in the *King Reports on Corporate governance* (which advocate for a stakeholder inclusive approach) may lead to directorial liability for breaching the duty of care and skill.<sup>268</sup>

In this case, the court found that the directors had breached their fiduciary duty to act *bona fide* in the best interests of the company. And although the court did not link the breach of the director's fiduciary duty and the application of *King Report*, subsequent judgements in the same vein may lead the way for the provisions of the King Reports to find their way into jurisprudence to become part of South Africa's common law.

#### 4.3.2 The Extension of Permission to Consider Non-Shareholder Constituency Interests.

The second variation pertains to whether the consideration of non-shareholder constituencies is extended to either the board of directors or board committees. In most states, the respective constituency statute specifically extends the permission to consider non-shareholder constituency interests to directors.<sup>269</sup> In other states, permission is extended to both the board of directors and /or committees of the board.<sup>270</sup>

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<sup>264</sup> IN ST 23-1-35-1 (f).

<sup>265</sup> Op cite note 237 at 14.

<sup>266</sup> See chapter 3 of this dissertation at 42.

<sup>267</sup> *Stilfontein Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd* 2006 (5) SA 333 (W).

<sup>268</sup> Section 76(3) of the Companies Act.

<sup>269</sup> Op cite note 226 at 834

<sup>270</sup> Ibid.

For example, section 1715 of the Pennsylvanian constituency statute specifies that ‘the board of directors, committees of the board and individual directors of a business corporation may... consider the interests of shareholders, employees, suppliers, customers, and creditors of the corporation, and upon communities’.<sup>271</sup> In Wyoming however, the duty to consider non-shareholder constituency statutes is extended to directors only.<sup>272</sup>

The position in South Africa is similar to the Pennsylvanian statute. Section 72(4) of the Companies Act places the consideration of non-shareholder constituency interests within the ambit of the SEC-a board committee. The question that comes to mind pertains to whether there are any differences between placing the consideration of non-shareholder constituency interests within the ambit of the board of directors versus delegating this authority to a board committee.

When the duty to consider non-shareholder constituencies is extended to the board of directors, decisions to protect these corporate constituents are taken at an executive level.<sup>273</sup> When this authority is delegated to a board committee, on the other hand, such a committee can provide specialised knowledge to the rest of the board.<sup>274</sup> And as a result, the board of directors is better informed because the committee has superior knowledge regarding the protection of non-shareholder constituencies.<sup>275</sup>

While there are practical differences between extending the duty to consider non-shareholder constituency interests to the board of directors as opposed to a board committee, there are no legal consequences of doing so because the board remains responsible for the proper performance of delegated tasks.<sup>276</sup>

#### 4.3.3 *The Mandatory versus Discretionary Consideration of Stakeholder Interests*

The third variation concerns whether the duty placed on directors to consider non-shareholder constituency interests is mandatory or discretionary. Some constituency statutes place a mandatory duty on directors to consider non-shareholder constituency interests while others

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<sup>271</sup> 15 Pa.C.S.A. § 1715.

<sup>272</sup> WYO.STAT. ANN § 17-16-830(g).

<sup>273</sup> Op cite note 226 at 835.

<sup>274</sup> John McMullen, ‘Committees of the Board of Directors’ (1974) 29 *Business Lawyer* 3 at 770.

<sup>275</sup> Ibid.

<sup>276</sup> Most states that have statutes which specify that directors remain responsible for delegated tasks. See op cite note 274 at 767. Also see *Re Barings plc (No 5)* [1999] 1 BCLC 433 (ChD).

merely make such consideration discretionary.<sup>277</sup> A mandatory duty means that a director must take the various interests into account in the decision-making process whereas a discretionary duty means that the directors will have to make a judgement call in that regard.<sup>278</sup>

The constituency statute in Idaho makes it mandatory for directors to consider non-shareholder constituency interests.<sup>279</sup> The statute employs the word *shall* as opposed to *may*.<sup>280</sup> As such it follows that a director may incur liability for failing to consider the interests of a particular non-shareholder constituent.<sup>281</sup>

It has been argued that a mandatory prescript on directors to consider non-shareholder constituency interests sets the tone for managerial opportunistic behaviour. According to Keay, directors could make self-serving decisions disguised as an act of balancing the various stakeholder interests and no one could challenge the conclusion at which the directors arrived.<sup>282</sup>

Nonetheless, most of the other states leave the consideration of non-shareholder constituency interests to the discretion of directors. For example, the Minnesota constituency statute provides that ‘in discharging the duties of the position of director, a director may, in considering the best interests of the corporation, consider the interests of the corporation's employees, customers, suppliers, and creditors, the economy of the state and nation, community and societal considerations, and the long-term as well as short-term interests of the corporation and its shareholders including the possibility that these interests may be best served by the continued independence of the corporation’.<sup>283</sup>

The Florida constituency statute also gives directors discretion to consider non-shareholder constituency interests.<sup>284</sup> Both Florida and Minnesota statutes employ the word *may* which implies that directors have wider discretion in carrying out their responsibilities to

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<sup>277</sup> Edward Adams and John Matheson ‘A statutory Model for Corporate Constituency Concerns’ (2000) 49 *Emory Law Journal* at 1089.

<sup>278</sup> *Ibid.*

<sup>279</sup> ID ST § 30-1602 provides that ‘In discharging the duties of the position of director of an issuing public corporation, a director, in considering the best interests of the corporation, shall consider the long-term as well as the short-term interests of the corporation and its shareholders including the possibility that these interests may be best served by the continued independence of the corporation. In addition, a director may consider the interests of Idaho employees, suppliers, customers and communities in discharging his duties’.

<sup>280</sup> ID ST § 30-1602.

<sup>281</sup> *Ibid.*

<sup>282</sup> *Op cite* note 134 at 602.

<sup>283</sup> M.S.A. § 302A.251.

<sup>284</sup> FL ST § 607.0830(3).

the company.<sup>285</sup>

In South Africa, the position is unclear because, as mentioned previously, there is no statutory pronouncement on the issue in the Companies Act. Section 72(4) read with Regulation 43 of the Companies Act does not provide clarity as to whether the mandate to monitor how the operations of the company impact non-shareholder constituencies is to be done in a mandatory or discretionary fashion by the SEC.<sup>286</sup>

However, the provision does provide that only certain companies are required to appoint an SEC.<sup>287</sup> From this, we can deduce that the consideration of non-shareholder constituency interests could be either mandatory for prescribed companies only.

This assertion is merely speculative because Regulation 43 explicitly provides that the SEC is required to monitor the company's standing as it pertains to non-shareholder constituencies.<sup>288</sup> The provision does not prescribe whether the mandate to monitor is mandatory or discretionary. And as mentioned previously, it is also not clear whether the requirement to *monitor* non-shareholder constituencies is the same as *considering* their interests.

Be that as it may, the fact that the JSE requires listed companies to provide an annual account of how the operations of the company impact on society and the environment (in compliance with King IV Report on Corporate Governance) implies that the consideration of non-shareholder constituency interests is not discretionary for listed companies in South Africa.

#### *4.4 The Enforceability of Constituency Statutes*

Although non-shareholder constituencies are the intended beneficiaries of constituency statutes, none of the constituency statutes provide a mechanism to enforce the rights afforded by the statutes.<sup>289</sup> Put another way, constituency statutes fail to provide non-shareholder constituencies with enforceable rights which means that should directors fail to take their interests into account when managing the affairs of the company, there is no basis upon which

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<sup>285</sup> FL ST § 607.0830(3) and M.S.A. § 302A.251 respectively. See also Janette Meredith Wester 'Achieving a Proper Economic Balance: Non-shareholder Constituency Statutes' (1990) 19 *Stetson Law Review* 2 at 615.

<sup>286</sup> My emphasis.

<sup>287</sup> Section 72(4)(a) of the Companies Act 71 of 2008.

<sup>288</sup> Reg 43(5)(a) of the Companies Regulations.

<sup>289</sup> Op cite note 237 at 14.

accountability can be attributed<sup>290</sup>

To demonstrate, some statutes such as the ones in Nevada and New York explicitly deny non-shareholder constituencies with legal standing to enforce the rights which the constituency statutes purport to afford them. For example, the Nevada statute provides that the consideration of non-shareholder constituencies does ‘...not create or authorize any causes of action against the corporation or its directors...’.<sup>291</sup> The New York statute encapsulates a similar provision albeit in less simple terms by providing that the consideration of non-shareholder constituency interests shall not create any duties owed by the director to them.<sup>292</sup>

The absence of an enforcement mechanism is a consequence of the notion that shareholders are the sole beneficiaries of the director’s fiduciary duties.<sup>293</sup> As a result, shareholders are the only stakeholders who can institute derivative action proceedings on behalf of the company against errant directors.<sup>294</sup>

In South Africa however, the introduction of the statutory derivative action contained in section 165 of the Companies Act arguably gives employees (through a trade union representative or another representative) *locus standi* to institute derivative action proceedings. Further to that, section 218 of the said Act also gives non-shareholder constituencies some right of recourse against errant directors for any loss or damage suffered as a contravention of the Act.<sup>295</sup>

Be that as it may, due to the fact that non-shareholder constituencies have not received formal recognition in the Companies Act, it is unlikely that South African courts will interpret these provisions in such a way that disregards the shareholder primacy norm.

#### 4.5 An Assessment of the of Constituency Statutes

Constituency statutes have been criticised for their lack of precision in that they do not provide directors with guidance regarding how they are to give attention to non-shareholder constituency interests.<sup>296</sup> The argument is that the constituency statutes require directors to balance competing interests without providing any means of weighing and measuring the

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<sup>290</sup> Ibid.

<sup>291</sup> NV ST 78.138(6).

<sup>292</sup> NY BUS CORP § 717(3)(b)(v).

<sup>293</sup> Op cite note 65 at 515.

<sup>294</sup> Op cite note 237 at 15.

<sup>295</sup> Section 218(2) of the Companies Act.

<sup>296</sup> Op cite note 251 at 113.

different interests which they are required to take into account.<sup>297</sup> Further to that, it has been argued that constituency statutes create “too many masters” in that they make it difficult, if not impossible, for directors to satisfy all of the different and competing interests.<sup>298</sup> And consequently, the directors are not accountable to anyone.

In addition to the lack of precision, Hanks contends that the constituency statutes create an unspecified relationship between the company and non-shareholder constituencies that entitles them to claim from the residual wealth of the company.<sup>299</sup> According to Hanks, non-shareholder constituencies are not only able to claim in terms of their statutory and contractual arrangements with the company, but they can also claim (again) along with the shareholders from whatever is left after winding up the company.<sup>300</sup> This essentially redistributes the shareholder’s wealth to the non-shareholder constituencies without providing a standard for doing so.<sup>301</sup>

Critics of the constituency statutes also claim that these statutes fail to establish the corporate objective and the beneficiary of the director’s fiduciary duties.<sup>302</sup> As such, constituency statutes fail to define the phrase ‘best interests’ of the company.

However, proponents of the constituency statutes hold that the phrase can be interpreted to mean the wide spectrum of stakeholder’s interests whereas opponents of the statutes interpret this phrase to mean the collective interests of the shareholders.<sup>303</sup>

Wallman submits that defining what the best interests of the company are is a cumbersome task.<sup>304</sup> However, this difficulty is reduced when the phrase is examined in light of the company’s ability ‘to produce wealth indefinitely’.<sup>305</sup> The phrase connotes the wealth-generating activities of today and tomorrow for the benefit of all stakeholders.<sup>306</sup>

As such, much of the tension that would result from competing interests is reduced when the phrase ‘best interests of the company’ is interpreted to refer to the interconnectedness of the various stakeholder interests.<sup>307</sup>

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<sup>297</sup> Lawrence Mitchell, ‘A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes’ (1992) 70 *Texas Law Review* 579 at 589.

<sup>298</sup> *Ibid* at 590.

<sup>299</sup> *Op cite* note 251 at 112-113.

<sup>300</sup> *Ibid*.

<sup>301</sup> *Ibid*.

<sup>302</sup> *Op cite* note 251 at 109.

<sup>303</sup> *Op cite* note 251 at 109.

<sup>304</sup> *Op cite* note 230 at 170.

<sup>305</sup> *Ibid*.

<sup>306</sup> *Ibid*.

<sup>307</sup> *Ibid*.



According to Mitchell, the criticisms levelled against the constituency statutes are based on a misconception of the director's fiduciary duties which has been exacerbated by inconsistent case law.<sup>308</sup> Mitchell submits that the director's fiduciary duties are multifaceted and are designed to address a multitude of conflicts of interests.<sup>309</sup> Fiduciary duties are not only designed to ensure that directors maintain their duty of loyalty to the shareholders which requires them to maximize shareholder wealth.<sup>310</sup> Instead, the duties are also designed to prevent directorial self-dealing and to protect the separate legal personality of the company.<sup>311</sup>

The director's duties were not designed to solely benefit one specific group of stakeholders.<sup>312</sup> The purpose and significance of the fiduciary duties are to benefit the company as represented by the various stakeholder interests.<sup>313</sup> Further to this, Mitchell contends that the corporate objective and the intended beneficiary of directors' fiduciary duties are blurred by the indiscriminate mismatching of the duties to cater exclusively to the shareholder's interests.<sup>314</sup>

The arguments that have been advanced to criticise constituency statutes are credible in that these instruments may not be the perfect solution to offer American non-shareholder constituencies protection because of the absence of an enforcement mechanism. However, the legal recognition of these stakeholders afforded by the constituency statutes represents a step in the right direction nonetheless.

It is unfortunate that in South Africa, employees are the only non-shareholder constituency with (indirect) *locus standi* to institute derivative action proceedings. However, it is submitted the extension of this *locus standi* reveals an inconsistency in the Companies Act because it is not coupled with a duty that legally recognises employees (and other non-shareholder constituencies) with enforceable rights to enforce recommendations set out by the SEC.

The second part of this chapter analyses the recognition and protection of non-shareholder constituencies in the UK to determine whether this model is more favourable to non-shareholder constituencies.

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<sup>308</sup> Op cite note 297 at 580-590.

<sup>309</sup> Ibid.

<sup>310</sup> Ibid.

<sup>311</sup> Ibid.

<sup>312</sup> Ibid.

<sup>313</sup> Ibid.

<sup>314</sup> Ibid.

#### 4.6 The Shareholder Value Theory in the United Kingdom

Similarly to the US and South Africa, the UK has maintained the shareholder primacy norm as a key component of its company law and ultimately the corporate objective of companies operating in the UK. Some of the earliest judicial pronouncements regarding the maximisation of shareholder wealth were made as early as 1885 in *Harris v North Devon Railway Co* where the court equated the interests of the company to with those of the shareholders.<sup>315</sup>

Although the judgement delivered in *Hutton v West Cork Railway* also maintained the shareholder primacy norm, this case indicated that a wider approach to conducting corporate affairs is plausible when the court stated that, '[t]he law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company'.<sup>316</sup> The 'cakes and ale' analogy indicates that directors may take non-shareholder constituency interests into account in so far as such consideration ultimately benefits the company and the shareholders. Further to that, this analogy also (arguably) denotes to the quintessence of the enlightened shareholder value theory.

#### 4.7 The Emergence of the Enlightened Shareholder Value Approach in the United Kingdom

During the late 1990s and early 2000s, a fundamental review of UK company law was undertaken by an independent committee known as the Company Law Review Steering Group (CLRSG).<sup>317</sup> The CLRSG was an independent group established by the UK Department of Trade and Industry (UK DTI) whose aim was to develop a simple, modern, efficient, and cost-effective framework for conducting business affairs in Britain.<sup>318</sup>

Similarly to the South African DTI, the CLRSG identified two theories (enlightened shareholder value theory and stakeholder holder theory) to address the issue of whose interests should be taken into account by directors when managing the affairs of the company.<sup>319</sup> The CLRSG noted that business affairs should be conducted in a manner that enhances the interests and welfare of different groups in society. However, it also went further to note that is important not to turn directors into moral, political or economic arbitrators.<sup>320</sup>

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<sup>315</sup> (1885) 20 Beav 348; 52 ER 651.

<sup>316</sup> Supra note 97.

<sup>317</sup> Richard Williams 'Enlightened Shareholder Value in UK Company Law' (2012) 35 *UNSW Law Journal* 1 at 361.

<sup>318</sup> Op cite note 37 at 233.

<sup>319</sup> Op cite note 134 at 589.

<sup>320</sup> The Company Law Review Steering Group, Department of Trade and Industry, *Modern Company Law for a Competitive Economy: Developing the Framework*, above n87 at 14.

The CLRSG rejected the stakeholder theory and noted that it was unworkable because it would necessitate substantial reform on the law on the director's duties and is thus undesirable in the UK.<sup>321</sup> According to the CLRSG, the ultimate objective of a company is to generate wealth for the shareholders.<sup>322</sup> As such, the CLRSG opted for the enlightened shareholder value theory as a better way of achieving wealth generation and competitiveness for the benefit of all.

The CLRSG explained the enlightened shareholder value theory as an approach whereby directors would be required to achieve the success of the company for the benefit of the shareholders whilst striking a balance between the different competing interests of the employees, community, suppliers, customers, and others.<sup>323</sup> The CLRSG also made note of the importance of maintaining effective relationships with these stakeholders.

The UK government responded to the CLRSG's recommendations by enacting a statutory version of the enlightened shareholder value approach (with slight variations) in section 172 of the Companies Act 2006.<sup>324</sup>

#### 4.8 Section 172 of the Companies Act of 2006

Section 172(1) of the UK Companies Act places a duty on directors to consider a non-exhaustive list of non-shareholder constituency interests when discharging their duty to promote the success of the company.<sup>325</sup> The interests which the directors are to have regard to include, but are not limited to, those of the employees, suppliers, customers, community and the environment.<sup>326</sup> Section 172(1) requires directors to consider these interests in good faith and in such a way that promotes the success of the company, which as demonstrated before, has been interpreted to mean the collective interests of the shareholders.

It is submitted that the language used in section 172 of the Companies Act of 2006 bears much resemblance to the 'cakes and ale' analogy referred to in *Hutton v West Cork Railway* in that the provision only implores directors to consider non-shareholder constituencies provided that such consideration promotes the interests of the shareholders.

The language used in section 172 of the Companies Act of 2006 also bears a lot of

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<sup>321</sup> DTI, London *Company Law Review Modern company Law for a competitive Economy. The strategic framework* (1999) at para 3.5.

<sup>322</sup> Ibid at para 5.1.5

<sup>323</sup> Op cite note 320 at 12-14.

<sup>324</sup> Op cite note 134 at 591.

<sup>325</sup> Op cite note 228 at para 326.

<sup>326</sup> Section 172(1)(a) -(d) of the Companies Act of 2006.

resemblance to the US constituency statutes. Both of the legal instruments used in these two countries to protect non-shareholder constituencies explicitly place a duty on directors to take non-shareholder constituencies into account when discharging their duties to the company.

This is different from the position in South Africa because the language in section 72(4) of the Companies Act read in conjunction with Regulation 43, namely the requirement to ‘monitor’ non-shareholder constituencies, creates much uncertainty regarding whether there is a similar duty placed on directors.

#### *4.9 An Analysis of the Prescribed Factors in Section 172 of the Companies Act of 2006*

As mentioned previously, section 172(1)(a)-(d) requires directors to have regard to the interests of employees, suppliers, customers, and community amongst others when promoting the success of the company for the benefit of shareholders. In this regard, there is little controversy over the consideration of the non-shareholder constituencies provided in the list because it reflects wide expectations of responsible business behaviour.<sup>327</sup>

It is, however, peculiar to note that creditors have been omitted from the list even though one category of creditors-suppliers- is mentioned.<sup>328</sup> In this regard, Keay submits that creditors have been omitted because they are offered protection to some extent by section 172(3).<sup>329</sup> He further contends that section 172(3) is reflective of the principles developed in case law that seek to protect the creditors of a company in financial distress.<sup>330</sup>

While USA constituency statutes and section 172 of the UK Companies Act provide a statutory list of non-shareholder constituencies to be considered by directors, the comparable provision in South Africa, section 72(4), merely provides for the establishment of the SEC with its functions set out in the Companies Regulations.

Further to that, the SEC’s mandate to monitor the interests of non-shareholder constituencies is stated in equivocal terms. The Regulations merely implore prescribed companies to monitor the company’s standing as it pertains to various international corporate governance conventions and local labour laws such as the Employment Equity Act and the Broad-Based Black Economic Empowerment Act.<sup>331</sup>

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<sup>327</sup> Op cite note 228 at para 326.

<sup>328</sup> Op cite 261 at 593.

<sup>329</sup> Ibid.

<sup>330</sup> Ibid. Also See *Walker v Wimborne* (1976) 137 CLR 1; 3 ACLR 529; *Grove v Flavel* (1986) 4 ACLC 654; 11 ACLR 161; *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 ACLC 215; 10 ACLR 395.

<sup>331</sup> Reg 43(5) of the Companies Regulations.

#### 4.10 Shareholder Primacy is retained in Section 172 of the Companies Act of 2006

Similarly to the position in the USA and South Africa, shareholder primacy still is a fundamental tenet of UK company law.<sup>332</sup> Therefore describing section 172 of the Companies Act of 2006 as an embodiment of the enlightened shareholder value theory creates the impression that it is a different concept from the shareholder primacy theory.<sup>333</sup> And although it can be argued that section 172 of the UK Companies Act *prima facie* deviates from the shareholder primacy norm, Esser and Delpont contend that shareholder holder primacy has been retained.<sup>334</sup>

Further to this, Keay submits that section 172 makes it clear that the directors owe their duties to the company and shareholders, not the wide range of non-shareholder constituency interests listed in sub-sections (a)-(d). Thus, ‘the overall effect of section 172(1) is that enlightened shareholder value can be interpreted as shareholders first interpretation’.<sup>335</sup>

According to Keay, the only enlightened aspect of section 172 appears to be the recognition of non-shareholder constituency interests.<sup>336</sup> As such, section 172 of the Companies Act of 2006 does not add anything new to English company law because this is a similar approach adopted in cases such as *Hutton v West Cork Railway Co.*

Thus, it would seem inaccurate to refer to section 172 as a radical departure from the shareholder primacy theory.<sup>337</sup> Although the essence of the provision accommodates the interests of non-shareholder constituencies, it fundamentally embodies elements of the shareholder primacy theory.<sup>338</sup>

#### 4.11 The Enforceability of Section 172 of the Companies Act of 2006

A key concern regarding section 172(1) pertains to what happens when directors merely pay lip service to the factors listed in section 172(1)(a)-(d) and they fail to consider non-shareholder constituencies. Put differently, this concern relates to the rights of recourse (if any) that may be available to non-shareholder constituencies.

Unfortunately, similarly to the USA constituency statutes, shareholders are the only

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<sup>332</sup> Op cite note 147 at 78.

<sup>333</sup> Op cite note 261 at 592.

<sup>334</sup> Op cite note 37 at 236.

<sup>335</sup> Op cite 333.

<sup>336</sup> Ibid.

<sup>337</sup> Op cite note 261 at 604.

<sup>338</sup> Op cite note 261 at 605.

stakeholders who can enforce a breach of duty by the directors.<sup>339</sup> Shareholders in the UK can bring a derivative suit against the directors on behalf of the company in terms of section 260(2) of the Companies Act of 2006 (subject to leave from the court).<sup>340</sup> The position in South Africa is different because the right to institute derivative action proceedings embodied in section 165 of the Companies Act is also extended to employees (and other non-shareholder constituencies provided that a legal interest is proved).

Furthermore, it is important to note that section 260(3) of the Companies Act of 2006 limits the circumstances in terms of which shareholders can institute a derivative suit. These circumstances are limited to ‘a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company’.<sup>341</sup>

#### *4.12 An Assessment of the Comparative Overview*

It has been argued that section 72(4) of the Companies Act is in effect the South African statutory adoption of the enlightened shareholder value theory.<sup>342</sup> However, the shortcomings of this provision render it inadequate to recognise and protect non-shareholder constituencies. And so, it is questionable whether section 72(4) does in fact give effect to the enlightened shareholder value theory. Further to that, the way the provision is drafted promotes a tick box culture<sup>343</sup> that emanates from the word *monitor* employed in Regulation 43(5(a)).

The standard constituency statute bears some resemblance to the UK’s statutory embodiment of the enlightened shareholder value theory.<sup>344</sup> And although these two legal instruments offer legal recognition to non-shareholder constituencies, they do not offer them protection because there is no provision for a mechanism to enforce the legally recognised rights. Thus, it follows that both the USA and the UK instruments still promote the shareholder primacy norm albeit through the lens of non-shareholder constituencies.

Accordingly, the American constituency statutes and section 172 of the Companies Act of 2006 do not fundamentally add anything new to what a director is already obligated to do. At best, these legal instruments point the way towards a more stakeholder centric approach<sup>345</sup>

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<sup>339</sup> Section 260(1) of the Companies Act of 2006.

<sup>340</sup> Section 178(2) of the Companies Act of 2006.

<sup>341</sup> Section 260(3) of the Companies Act of 2006.

<sup>342</sup> Op cite note 65 at 523.

<sup>343</sup> Ibid.

<sup>344</sup> Op cite note 147 at 79.

<sup>345</sup> Op cite note 345 at 37.

because the discretion given to directors to have regard to non-shareholder constituency interests arguably disrupts the traditional focus of exclusive shareholder wealth maximization.<sup>346</sup>

Be that as it may, the legal mechanisms contained in section 172 and the constituency statutes provide stability to inconsistent case law.<sup>347</sup> As previously mentioned, this is because at common law, it was unclear whether directors were legally permitted to take non-shareholder constituencies into account when managing the affairs of the company however, section 172 and the constituency statutes expressly permit directors to take non-shareholder constituency statutes into account in their decision-making.

The constituency statutes and section 171 have also been criticised for a lack of clarity and guidance regarding how directors are to weigh, prioritize and reconcile the various non-shareholder constituency interests.<sup>348</sup> On that note, it is arguable whether these legal instruments offer non-shareholder constituencies with any real benefits.<sup>349</sup> Further to that, non-shareholder constituencies have very little power to influence directors to make decisions that protect their interests.<sup>350</sup>

The most far-reaching concern regarding section 172 and the constituency statutes is perhaps that they fail to provide non-shareholder constituencies with a mechanism to hold directors accountable.<sup>351</sup> Thus it appears unlikely that they can successfully institute proceedings against directors on the basis that they failed to have regard to non-shareholder constituency interests during the decision-making process.<sup>352</sup>

#### *4.13 Chapter Conclusion*

This chapter examined and compared the different models of non-shareholder constituency protection in the UK and USA to determine whether there are any lessons from which South Africa could learn.

It was found that the protection of non-shareholder constituencies is afforded by statutory legal instruments known as constituency statutes in the USA and in the UK, protection is conferred by section 172 of Companies Act of 2006. These legal mechanisms explicitly

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<sup>346</sup> Op cite note 134 at 611.

<sup>347</sup> My emphasis.

<sup>348</sup> Op cite note 261 at 42.

<sup>349</sup> Ibid.

<sup>350</sup> Ibid.

<sup>351</sup> Op cite note 261 at 41.

<sup>352</sup> Ibid.

permit directors to consider non-shareholder constituencies when conducting the affairs of the company.

The USA constituency statutes differ in certain regards across the different states but they all generally permit the consideration of non-shareholder constituencies as a unifying factor. In the UK, section 172 of the UK Companies Act encapsulates the enlightened shareholder value theory which has been described as an amalgamation of shareholder primacy theory and the stakeholder theory.

Although section 172 and the constituency statutes statutorily permit directors to consider non-shareholder constituency interests, they have been criticised for their lack of precision and the absence of an enforcement mechanism that non-shareholder constituencies can use to enforce their legally recognised rights. In that regard, many of the arguments that have been levelled against the stakeholder theory have also been advanced against the constituency statutes and section 172 of the Companies Act of 2006.

The comparable provision in South Africa, namely section 72(4) of the Companies Act read in conjunction with Regulation 43, merely implores prescribed companies to monitor how the operations of the company impact non-shareholder constituencies, the provision does not extend legal recognition to non-shareholder constituencies.

However, the indirect *locus standi* extended to employees (and to a certain extent other non-shareholder constituencies) in section 165 of the Companies Act offers some right of recourse to institute proceedings on behalf of the company. Be that as it may, it is unlikely that section 165 will offer much assistance to non-shareholder constituencies unless the ambiguities and shortcomings in section 72(4) are cleared up to formally and unequivocally recognise non-shareholder constituency interests in the same way section 172 of the Companies Act of 2006 and the constituency statutes have.

The outright extension of enforceable rights to non-shareholder is a cumbersome task fraught with many shortcomings, uncertainties, and ambiguities. This process would require the formulation of a normative theory that is beyond the scope of this thesis.

To reflect the paradigm shift towards stakeholder protection undertaken in the USA and UK, South Africa will have to formally and unequivocally recognise non-shareholder constituencies as corporate constituents in the Companies Act in a similar fashion. Be that as it may, it must be borne in mind that the paradigm shift undertaken in the USA and UK is hardly a radical departure from the shareholder primacy norm, but it is nonetheless a step that can be taken to bring South Africa in line with international standards.



However, caution should be exercised when transplanting solutions from developed countries such as the USA and the UK to a developing country such as South Africa. In this regard, a paradigm shift that advocates for a bespoke committee that recognises non-shareholder constituencies may be a better and more appropriate solution for South Africa's unique context.

## CHAPTER 5: CONCLUSION AND RECOMMENDATIONS

### 5.1 CONCLUSION

This dissertation examined how shareholders continue to be the only stakeholders to hold a privileged position in the governance of companies in that they enjoy they are the sole beneficiaries of the directors' fiduciary duties. However, it was also submitted that the exclusive focus on shareholder protection is a narrow approach to conducting the affairs of the company because the interests of shareholders are given primacy at the expense of non-shareholder constituency interests.

The paradigm shift towards an approach that seeks to recognise and protect non-shareholder constituencies is arguably reflected (with limited application) in section 72(4) of the Companies Act read with Regulation 43 of the Companies Regulations. These provisions require certain companies to appoint an SEC.

The presence of a structured committee such as the SEC in a company serves as a useful tool that companies can use to monitor how the operations of the company impact a broad range of non-shareholder constituencies including employees, the environment, communities, and suppliers. The role of the SEC in a company is also to ensure that CSR objectives are embedded in the core of the company's activities and strategies to add value beyond making profits.

In this regard, it was found that the SEC presents an ideal conduit through which it can sensitize the board of directors to issues of national priority and to ensure that the company does not fall foul of the provisions of the Bill of Rights prescribed by section 7 read with section 5 of the Companies Act.

This dissertation examined how several shortcomings and uncertainties gravely undermine the efficacy of the SEC. It was found that the inefficacy of the SEC stems from a plethora of shortcomings and uncertainties that emanate from the legislature's poor formulation of section 72(4) of the Companies Act read with Regulation 43. The Companies Act and accompanying Regulations refer to generic terms of reference regarding the role and responsibilities of the SEC. Further to that, the powers, functions, objectives, and purpose of the SEC are not made clear.

On that basis, it was submitted in this dissertation that the SEC's greatest flaw is the absence of an enforcement mechanism that arguably stems from the legislature's requirement for certain companies to *monitor* as opposed to *consider* or *protect* non-shareholder constituency interests. The use of the word monitor implies that the SEC is merely required to

keep a record of how the company's activities impact non-shareholder constituencies and to observe whether the company's CSR activities are carried out correctly. As such, the SEC's mandate to monitor how the operations of the company impact non-shareholder constituencies do not afford them formal recognition and legally enforceable rights in the Companies Act.

Further to that, it was also submitted that the efficacy of the SEC is negated by a lack of consensus regarding its appointment. According to the literature review conducted pertaining to the legal status of the SEC, it was found that there is a lack of consensus regarding whether the SEC is appointed by either the board of directors and is thus a board committee, or whether it is appointed by the shareholders and is accordingly a company committee.

In response to the research question raised in this dissertation, it was submitted that based on the short title of section 72(4) of the Companies Act read in conjunction with Regulation 43, the SEC is a board committee because this is the interpretation that best promotes the purpose provisions contained in section 5 read with the section 7 of the Companies Act, namely to reaffirm the concept of a company as a vehicle for attaining social objectives and the concomitant national issues of priority.

In this regard, it was submitted that the director's fiduciary and statutory duties apply to directors, non-directors, executive, and non-executive directors who comprise the SEC. However, these duties are not owed to non-shareholder constituencies because the shareholders are the exclusive beneficiaries of the director's duties. On that basis, it was found that section 72(4) read with Regulation 43 is not a viable mechanism that can be enforced to protect non-shareholder constituencies.

This dissertation also demonstrated how the inability of the SEC to protect non-shareholder constituencies is a direct consequence of its philosophical foundation. During South Africa's company law reform process, the DTI recommended the enlightened shareholder value theory as the philosophical foundation of the new Companies Act and consequently the SEC.

However, an analysis of the Companies Act revealed that the theory adopted is unclear, but it was suggested that the approach adopted by the legislature is perhaps one that is "in-between" the shareholder primacy theory and enlightened shareholder value theory. This analysis was based on the fact that the only echoes of the enlightened shareholder value theory in the Companies Act are to be found in section 72(4) read with Regulation 43 and section 218 of the Companies Act.

In the comparative analysis encompassed in Chapter 4 of this dissertation, it was submitted that the USA and the UK have also deliberated on the shareholder value theory, the

enlightened shareholder theory and the stakeholder theory as the theories to be adopted as the philosophical foundation of the company law regimes of these two countries.

It was found that in the USA, the protection of non-shareholder constituencies is afforded by statutory instruments known as constituency statutes. An examination of the constituency statutes found that they vary across the different USA States but they all generally permit directors to consider non-shareholder constituencies in their decision-making as a unifying factor.

In the UK, the protection of non-shareholder constituencies is conferred by section 172 of Companies Act of 2006. A comparison between the US Constituency Statutes and section 172 of Companies Act of 2006 revealed that both legal instruments explicitly permit directors to consider non-shareholder constituencies when conducting the affairs of the company. It was also found that in the UK, section 172 of the Companies Act of 2006 is said to encapsulate the enlightened shareholder value theory which has been described as an amalgamation of shareholder primacy theory and the stakeholder theory.

It was submitted that although the two legal instruments in the USA and the UK referred to above offer non-shareholder constituencies legal recognition, they do not afford them legal protection because neither legal instruments make provision for a mechanism to enforce the legally recognised rights. In this regard, it was submitted that both instruments promote the shareholder primacy norm albeit through a stakeholder lens and is thus insufficient to protect the rights of non-shareholder constituencies.

The comparative analysis also revealed that the position in South Africa's is not different to the one in the USA and UK because the Model Business Corporation Act (MBCA), the Delaware General Corporation Law (DGCL), the Maryland General Corporation Law (MGCL) and the UK Companies Act of 2006 has played a huge role in the development of the South African Companies Act 71 of 2008. And on that basis, it was submitted that the shareholder primacy norm has also been retained in South Africa.

Nonetheless, the position in South Africa is slightly different in that the indirect *locus standi* extended to employees (and other non-shareholder constituencies with legal standing and leave from the court) pursuant to section 165 of the Companies Act offers some right of recourse to institute derivative action proceedings on behalf of the company. However, due to the absence of legally recognised rights in the Companies Act that can be enforced, it is unlikely that section 165 will offer much assistance to non-shareholder constituencies. In this regard, to improve the efficacy of the SEC, the following recommendations are submitted:

## *5.2 Recommendations*

It is hereby recommended that to reflect a similar paradigm shift undertaken in the USA and the UK to protect non-shareholder constituencies, South Africa will have to formally and unequivocally recognise non-shareholder constituencies as corporate constituents in the Companies Act in a similar fashion.

However, caution should be exercised because it may be inappropriate to directly transplant the solutions adopted in developed countries such as the USA and the UK to a developing country such as South Africa. On this note, it is submitted that the South African legislature should work towards formulating a paradigm shift that advocates for a bespoke committee that recognises non-shareholder constituencies with enforceable rights. This can be achieved by a legislative amendment of section 72(4) read with Regulation 43.

In the first instance, section 72(4) of the Companies Act should be amended to expressly provide that the mandate of the SEC is to consider and not monitor the interests of legitimate and identifiable non-shareholder constituencies, namely, employees, communities, suppliers, and the environment when promoting the success of the company.

Secondly, it is submitted that clarity should be provided regarding the appointment of the SEC. In this regard, section 15 of the Companies Act Amendment Bill of 2011 should be passed as law. Section 15 proposes that the SEC should be appointed by the incorporators of the company or by the board of directors within 40 days of the company's incorporation. As such, this proposed amendment is in line with Rossouw's recommendation on how to reconcile the nuances between Regulation 43(2) and Regulation 43(3).

Thirdly, the reference to international corporate governance instruments such as the United Nations Global Compact principles and the OECD recommendations regarding corruption in Regulation 43(5) should be amended to refer to local instruments such as King IV Report on Corporate Governance as suggested by Kloppers.

Finally, it is submitted that the "merry-go-round" theory coupled with the derivative action formulated by Esser would be a useful tool for directors regarding how they are to weigh and balance the competing stakeholder interests.

## *5.2 Areas for Future Research*

Despite the recommendations made above, it is further submitted the legislative amendments to section 72(4) read with Regulation 43 will not suffice to offer substantive protection to non-shareholder constituencies. However, the substantive protection of non-shareholder

constituencies can be achieved by the legal recognition of non-shareholder constituencies as corporate constituents coupled with enforceable rights in the Companies Act.

It must, however, be borne in mind that this is a cumbersome task fraught with many shortcomings, uncertainties, and ambiguities. Accordingly, such a process would require the development of a normative theory that would provide the basis for the attribution of responsibilities to members of the bespoke committee suggested above and thus presents as an area for future research.

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